THE LONDON CAPITAL MARKET

Its Structure, Strains and Management

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PREFACE

The objects of this book are to describe the functions and functioning of the capital and money markets in the City of London, to discuss the strains that have arisen in them under post-war conditions, and to explain the ways (they are very different from the classical ways) in which the Bank of England's system of monetary management now works.

My main sources of material have been the papers that have passed across my desk as a financial journalist in the past five years, and the workaday discussions that I have had with my friends in the City during that period. But since one of my principal aims has been to gather together in a single book information about the City which at present tends to be diffusely spread through many more specialist works, much of the material is also second-hand. Wherever I have been conscious of a direct debt to any other published work I have made the due acknowledgment in a footnote; if there are any acknowledgments that I have not made and should have made, it will be because of the bewildering speed with which work done at the Universities or in the City becomes incorporated in what those who daily discuss these matters come to regard as the established corpus of economic thought or of City lore.

I have always had a great aversion to discussing or being taught any subject without some idea of the probable size of the different items involved. This book therefore contains some new – and very hazardous – estimates about such things as the size of the national capital and the pattern of security holdings as between investment institutions and persons. It will be disappointing if official or semi-official estimates of some of these quantities do not become available in the course of the next few years; and, if and when they do, it will be surprising if they do not prove some of my estimates to be wrong. But it seems to me pointless to discuss the problems of the capital market without setting down the best estimates one can of their probable magnitudes, although always with due warnings about the hazards attached.

My gratitude is due to a long list of friends who have helped me in my daily work – and also, sometimes indirectly, in compiling this book. It would be tedious to name them all – and also unfair, lest it might seem to saddle them with any responsibility for certain of the contentious opinions I have expressed. But I must record a quite especial debt to Mr W. T. C. King, under whose expert tutelage I cut my teeth as a financial journalist and without whose constant encouragement and guidance I would never have been able to enter this field. Necessarily, however, any errors, omissions, or distortions of fact or emphasis that are found here will be entirely my own fault. A final acknowledgment must be to my wife, who typed most of the manuscript and bore the domestic inconveniences associated with its delivery with astonishing forbearance.

N.A.D.M.

August 1954.

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PART I

The Structure and Its Strains

CHAPTER I

THE PROBLEMS AT ISSUE

According to United Nations statistics the people of the United Kingdom is the sixth or seventh richest in the world. Its income per head is less than half of that of the people of the United States (in fact, at current exchange rates, it is just about equal to that of the average American negro); but, apart from that very rich country, only the Canadians, the New Zealanders, the Swedes, the Swiss and (intermittently) the Australians exceed us – and they not by much. Yet in its acreage of cultivatable land per head, Britain is probably exceeded by at least twenty other countries. And in the number of hours worked per man per week the British people is also a long way down the league. It is true that British workers are more skilled than those in most poorer countries; but this is usually because, being richer, British workers have had greater opportunities for education and are physically stronger – so that to argue that this greater skill is a principal cause of our relative wealth is to mix up cause and effect.

The fact must be faced therefore that the principal cause of Britain's high standard of living is not that it has a lot of land, nor yet that Britons are unusually skilled, nor yet that Britons work unusually hard. The explanation is to be found instead in the vast accumulation of national capital that Britain has inherited as a result of its high rate of savings in the past. In all the forms of existing earning assets which are measurable – in factory space per worker, in machines per worker, in power per worker, in railway rolling-stock per worker, in foreign investments per head – Britain far surpasses the vast majority of foreign countries. Indeed, when the advantages of such intangibles as accumulated marketing experience and capacity are taken into account, it is probable that the average person in Britain has had a greater earning power per head built up for him by his forefathers (as distinct from innate in his own land) than his counterpart in any country outside North America.

This productive national capital has come into existence as a result of two fortunate features of British history. The first is that our fathers and grandfathers saved a high proportion of what they earned; it is only by saving that one can store up capital for the future. The second is that in the last two and a half centuries this country has built up a uniquely excellent mechanism for transferring savings, for a consideration, from the hands of the men who have saved into the hands of businesses that are able and eager to use savings to good advantage. This mechanism is the capital market which, to this day, has its centre of gravity – and indeed nine-tenths of its being – in a handful of institutions that have set up their head offices in a single square mile in the City of London.

Of course these institutions in the City – the banks, discount houses, merchant banks, insurance companies, the Stock Exchange and other financial organizations that will be discussed in this book – have been set up because their owners and directors and members think that money can be made out of them. But, generally speaking, money can be made out of any organization only if it fulfils a real national need. There is, in fact, a good case for saying that the obliteration of the expertize accumulated in the square mile of the City of London could cause a reduction in the Standard of living of the ordinary British worker greater than that which would be caused by the obliteration of almost any other single national asset.

Once the truth is recognized that the main reason why Britain is enjoying a relatively high standard of living today lies in its high and well-directed rate of capital accumulation in the past, the importance of studying the capital market and its present-day strains becomes apparent. There are four main questions at issue. The first is: Is Britain still adding to its capital stock at a sufficient pace to keep high up among the wealthy countries of the world? In other words, is its present rate of saving high enough? Later in this book – starting indeed from the second chapter of it – we shall summarize the available statistics on this point. The conclusion must be that although Britain is probably still adding to its net capital stock in most years, it is not doing so as swiftly as it should. Certainly it is doing so less swiftly than some of its principal competitors abroad.

The second question is: Has Britain still got as efficient a capital market as it needs? In other words, can we be satisfied with the mechanism that we have got for transferring funds, for a consideration, out of the hands of the people (the very widely scattered people) who are saving into the hands of people or businesses who want to build factories or houses, or install new machinery, or make additions to their stocks of raw materials, or undertake other forms of real capital formation? Here the answer can be a reasonably cheerful one. The mechanism that we have in London for the transference of capital – and the mechanism, which is inevitably intermingled with it, for the provision of an efficient medium of exchange – is still the envy of most countries in the world. Every now and then assiduous Europeans, Asiatics, Africans and even Americans come down to the City of London and write voluminous (though sometimes rather jejune) theses demanding that similar mechanisms should be set up in their own homelands overnight. But the fact that the mechanism of the City of London is probably more efficient than any similar mechanism abroad does not mean that it is necessarily ideal. In this book we will have to study the structure of the London capital market in some detail, and be on the look-out for places in which – under the peculiar conditions of this mid-twentieth century – the shoe may be beginning to pinch.

The third question is a more complicated one. It is: Do the forms of real capital formation that we are undertaking seem to be the most desirable forms? There is a very real dilemma here. The type of real investment that may be most urgently needed in modern Britain is investment in productive industry. But investment in industry is inevitably risky, and an ever-larger part of the nation's annual quota of savings is piling up in the hands of people or institutions who cannot afford to put their savings at great risk. This is an inevitable consequence of the re-distribution of incomes in favour of the poor. It is only when an individual is rich enough to save at a high rate that he can afford to put some of those savings at risk (in the hope of securing large rewards if the gamble comes off). The rest of us search around for savings media that offer us the highest possible degree of capital security. The result is that the Government – and the nationalized industries which can borrow under Government guarantee – can raise funds far more easily today than can private industrial concerns. We will be coming up again and again against this 'risk capital problem' throughout this book.

The fourth question is also a complicated one, and we will leave over detailed discussion of it to the second section of this book. It has already been emphasized that the rate at which

Britain can undertake real investment must depend on the rate at which it is willing to save. Each year the country has to decide how much of its current income it should devote to adding to the stock of national capital and how much it should 'blue' on current consumption. If, however, it tries to add, say, £3,000 million to its internal capital stock – that is to say, to spend £3,000 million on building new houses, installing new machinery, and laying in new hoards of raw materials and of other goods – while at the same time 'blueing' all but £2,500 million of its current income on current consumption, then it immediately finds itself spending £500 million more than it is earning; in other words, it finds itself running what is known as a 'balance of payments deficit' of £500 million. There is nothing strange and highbrow about this arithmetic. It simply amounts to saying that what one spends can never exceed what one earns – at least not for long; if there is such an excess, measures have to be taken to cut down spending. In the second section of this book (starting at Chapter 15) we will discuss the measures that the Government has taken to cut down spending during Britain's successive balance of payments crises since the war. We will pay especial attention there to the most intricate of these measures, namely the restrictive monetary policy that was inaugurated in November 1951. But for the first fourteen chapters of this book we can concentrate on the statistics, structure and strains of the capital market when divorced from this complication.

It is customary at this stage for the analyst to take time off for a nostalgic wail. The capital market and the City of London grew to their present eminence in the century before 1914, when Britain was not only saving enough to add to its own real capital at a faster rate than any other country, but was also (with considerable profit) investing its surplus savings at a prodigious rate abroad. Just before 1914 Britain was running an average balance of payments surplus of over £200 million a year, and it was devoting virtually all of this to profitable long-term foreign investment; as our national income was only about £2,000 million at that time, this means that we were investing abroad the extraordinary proportion of about one out of every ten pounds we earned. Perhaps the country will get back some way along the road to this happy position again; both the Labour and Conservative Governments since the war have set that as a national objective. But this will not be achieved unless the problems of the capital market are subject to much wider understanding and study.

And, embarking on such study, the impression that the reader should carry forward is not that of diminution of past glories, but of the might that remains. Thanks largely to the reputation that the City has built up, and despite present exchange controls, about two-fifths of all international trade (which totalled about £55,000 million in 1952) is financed in sterling; each of these sterling payments must lead to an entry in the books of some bank with an office in the City of London. Again, the British people themselves currently (1954) turn out about £15,000 million worth of goods and services a year. Most of these products must be involved in more than one money transaction – as the raw material is sold through the merchant to the factory, the factory's product through the wholesaler to the retailer and so on. Most of these transactions, together with similar transactions in second-hand goods, must again make their mark on some ledger in the City. Finally, the greater part of the national capital – which we will discuss in the next chapter and which must be worth somewhere around £40,000 million at current prices – is in the hands of people who either do not own the equipment concerned or who have borrowed money to buy it. This vast pattern of debt and of indirectness of ownership has as its corollary an even vaster pattern of securities and book entries that are dealt in – that is to say, sold by one saver to another – through the mechanism of the City of London. The City, in short, is no faded flower. It is the lively, throbbing – at times erratically throbbing – heart of the national economy. And if some of us who work in or write about it sometimes fail to express or even feel the magic sense of excitement that should lie around any throbbing heart, that is no reason why those who come down to look at the 'Square Mile' for the first time should miss it, too.

CHAPTER II

THE NATIONAL CAPITAL

It is always wise to be wary of economic statistics; they are much more hazardously estimated than many people realize and they have a habit of becoming out of date as soon as they appear in print. But it is impossible to form a coherent picture of the British capital market – that is to say, of the mechanism by which the British people's savings flow into productive investment – unless one has at least some idea of the orders of magnitude involved. And the first rough estimate one needs to make is obviously about how large the national capital is now, and how swiftly or how slowly it is growing. But, before we do this, we had better define carefully what the national capital is.

By the national capital we mean simply the value of all accumulated wealth belonging to Britons at this time. It can be divided into four main categories:

(1) *Accumulated Consumer Goods.* By this is meant simply the clothes, furniture, etc. that you and I have lying around our houses.

(2) *Net Overseas Investments.* By this is meant the value of overseas businesses, securities and other assets owned by Britons—less businesses, securities and other assets in Britain which are owned by foreigners.

(3) *Working Capital.* By this is meant stocks of raw materials, the value of work actually in progress on factory floors at this time, and stocks of goods already made by our factories but lying about in warehouses and shops because they have not yet been sold.

(4) *Fixed Capital Equipment.* By this is meant all buildings (including private houses, business premises, railway lines and roads); and all machinery and other tools used for the production of new wealth in Britain.

All goods and wealth existing in the country at this moment must fall under one or other of these four categories.

In this book, however, we are going to cheat a little by leaving our first category – accumulated consumer goods – out of account. At this writing the British people are spending about £11,000 million a year on consumer goods and services; but many of these consumer goods – food and newspapers and so on – disappear down our gullets or into our wastepaper baskets soon after we have bought them. Shortly before the war, when the British people were probably spending about £4,000 million a year on consumption, Lord Stamp estimated the value of accumulated consumer goods at only about £1,650 million; it seems probable that an equivalent figure for the accumulation today (and, of course, at today's prices) would be under £5,000 million.

But the excuse for ignoring this figure, as soon as we have thus mentioned it, is that accumulations of consumer goods do not represent productive capital. When Britain adds to its other three categories of capital – overseas investments, working capital, and fixed capital equipment – it adds to its future earning power; and it is this that most people mean when they talk about capital accumulation in a loose sense. It is also, of course, these last three types of capital accumulation that are of supreme importance if Britain is to keep its place high up among the wealthy countries of the world. Generally speaking, and apart from distortions caused by price changes, Britons can only add to these three types of productive capital if they refrain from spending part of their current incomes on consumption; in other words the amount of new accumulation of productive capital – along these three lines – which the country achieves in any one year must be equal to its saving in that year.

Net Overseas Investments

We can now turn to examine the probable size of Britain's productive national capital, under each of our three heads. We will look at net overseas investments first. Britain's investments and assets abroad fall into three main categories.

(1) The stocks, shares and other securities in business operating overseas held by British residents. There has been a very large accumulation of these – especially, of course, the accumulation in the days before 1914 when many foreign railways, mines, plantations, etc. were built up with British money, much of which was raised on the London Stock Exchange.

(2) The so-called 'direct overseas investments' which have been undertaken in the past by British business concerns.

For example, many important British concerns have subsidiaries in the overseas Commonwealth and other overseas countries.

(3) The official holdings of dollar securities and gold by the British Government.

Against these must be set Britain's overseas debts. These, too, fall into three main categories:

(1) Many foreign governments and banks hold their exchange reserves in short-term British Government securities or even in balances at British banks. These foreign exchange reserves are usually known as the sterling balances; but officialdom sometimes likes to call them Britain's 'net quick external liabilities'.

(2) Foreign government loans to the British Government—especially, of course, the large and generous loans that the United States and Canada made to this country during and since the war.

(3) Finally, some private individuals or businesses overseas own securities or assets or subsidiary companies in Britain. For example, American firms (according to American figures) owned subsidiaries in Britain worth about £350 million at the end of 1952; this is probably now the biggest individual item in this field.

There are, of course, some other driblets – such as odd pieces of real property abroad owned by private British residents and working balances in foreign exchange held by British banks – but the above are the main heads. Before trying to assess the relevant totals, and changes in them since the war, it should be explained that two factors can alter the total of Britain's overseas investments. The first is if the country is virtuous and runs a balance of payments surplus; this, of course, is merely another way of stating the obvious fact that if we do not spend all our current earnings at home we have something over to buy new assets abroad or to pay back some of our debts to foreigners. The second factor is if the country is lucky – in other words, if the price of the securities and other assets that Britons hold abroad happen to go up by more than the prices of securities and assets that foreigners hold in Britain.

So much for the definitions. What now of the totals? As a starting point, it seems probable that Britain's net investments abroad were worth between £4,000 and £4,500 million in 1938. This is a very rough estimate. But Mr A. R. Conan (in his book on *The Sterling Area*[1]) has estimated that the market value of private British overseas investments (both securities held by individuals and direct overseas investments by British firms) was £4,500 million in 1938. We have official figures to show that Britain's gold and dollar reserves exceeded its 'net quick external liabilities' by some £130 million at the outbreak of war. And it is believed that other foreign investments in Britain at that time were less than £500 million. This suggests a net total of around £4,100 million or £4,200 million in 1938.

During the war Britain's industries were working full blast to make armaments, and the country had no resources to spare for exports. So it had to pay for many of the imports it needed by selling out British assets abroad, and running up large debts to foreigners on the sterling balances and elsewhere. An official estimate is available that Britain's net external disinvestment in the war was around £4,200 million.[2] If so, by the end of 1945 our net investments were probably about nil – neither a creditor nor a debtor were we. This estimate may cause surprise, because it is widely believed that Britain came out of the war owing money to all and sundry. But even in 1946, it should be noted, property income received from abroad totalled £216 million, while property income paid abroad (including foreign taxes paid by British concerns) was £178 million. Since many of our overseas debts to foreigners were held by those foreigners in low-yielding British Treasury bills – but most of our overseas assets were risky but high-yielding plantations, mines, and other enterprises – this is not inconsistent with a balance in the capital value of Britain's external debts and credits at the end of 1945.

What happened between 1945 and 1952? Between those years, Britain had a total balance of payments deficit of something over £650 million; but, as it was given over £600 million of free aid by America and others in these seven years, its net new disinvestment abroad amounted to only about £50 million. Included in this net disinvestment, of course, were the large loans that it received (along with certain free gifts) from the United States and Canada; and after devaluation in 1949 the sterling value of these debts had to be written up by some £500 million. Against this, however, it seems reasonable to suppose that the market value of Britain's productive overseas investments rose by at least sufficient to cover the depredations that could have arisen from this balance of payments deficit and this revaluation factor. It should be remembered that many of Britain's foreign investments consist of rubber plantations, tin mines, oil investments, and other commodity producing enterprises overseas; many of these were in very bad shape at the end of 1945, but in much better shape seven years later (we are assuming at this writing that Britain's oil investments in Persia are not irretrievably lost). Moreover, despite the misfortune of Abadan, Britain's income from overseas property rose from £216 million in 1946 to £484 million in 1952 (after touching £614 million in 1950, before we lost Abadan): this £268 million rise in income between 1946 and 1952 was accompanied by an increase of over £100 million in the interest and dividends that Britain paid to foreigners, but the balance of advantage was clearly on our side. It must have sufficed to wipe out the effect of our £50 million of net overseas disinvestment.

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[1] Conan, A. R. (1952). The Sterling Area (Macmillan) 192 pp., 16*s*.

[2] See Cmd. 6707. 'Statistical Material presented during the Washington Negotiations', December 1945.

If our estimates are right Britain's net capital balance abroad at the end of 1952 may have been made up somewhat as follows: on the debit side, £3,250 million of short-term sterling liabilities, over £2,000 million of past British Government borrowing from abroad (mainly the post-war American loans), and between £500 and £1,000 million of foreign-owned securities and business enterprises in Britain; on the credit side, £650 million of gold and dollar reserves and between £5,000 and £5,500 million of British-owned securities and enterprises abroad. All these are very rough estimates; but since it is silly even to pretend to measure the national capital in anything more than the roundest figures, the assumption of a rough balance between Britain's overseas investments (mostly high-yielding but risky productive investments) and its overseas debts (mostly low-yielding but statutory debts) seems reasonable enough.

Working Capital

We are fortunate in having official figures for Britain's working capital. According to the national income blue book for 1952, the value of stocks and work-in-progress in Britain was about £4,000 million at the end of 1945. By the end of 1952 it had increased by about £3,300 million, to £7,300 million. Of the increase in these seven years, about £2,700 million was due to price inflation and about £600 million to an increase in the volume of stocks.

The blue book also allows us to make a useful break-down of where these stocks were held. Of the total stocks of £7,300 million held at the end of 1952, manufacturing industry may have held about £1,700 million of raw materials and another £1,700 million of stocks of finished goods and work-in-progress; perhaps another £600 million of finished goods were held in Britain's shops; another £600 million may have been held on the farms (herds of cattle, growing crops and so on are counted as stocks); there was about £175 million of raw materials in the Government's strategic stockpile; and the other £2,500 million odd of stocks may have been held in non-manufacturing industry (like the coal-mines, the service industries, transport, electricity and gas supply, and so on). This is a widely diversified list; and it will be useful to remember this diversity when we come on, later in this book, to discuss how working capital is financed.

Fixed Capital Equipment

When we turn to the all-important field of fixed capital equipment, unfortunately, we run straight into an almost insurmountable statistical difficulty. This is the difficulty of defining prices. There was no such major difficulty present in our (still very rough) assessment of net overseas investments earlier in this chapter, because many of these investments are held in the form of securities which have a quoted market price. There was no similar difficulty about assessing the value of working capital, because working capital consists of stocks of raw materials which have recently been sold (at some stated price) or of half-finished or finished goods which are shortly to be sold (at some stated prices also). But for fixed capital we are in a quandary. How, for example, do we assess the 1952 price of a house built in 1925 – at its original cost less wear and tear, or at its replacement cost, or at the price that it would have commanded in the scarcity market of that time when there were restrictions on new building?

We obviously need to walk very warily, and can only give very rough figures indeed. A very rough starting point is provided by Cmd. 6707 (the statistical material presented during the Washington negotiations in 1945, to which we have already referred). It was suggested there that as a result of the depredations of war – when much of Britain's fixed capital equipment had to be allowed to waste away without replacement – the gross national capital might have come down to about £22,700 million in 1945, compared with about £30,000 million (in terms of 1945 prices) in 1939. If we make allowances for working capital and accumulated consumer goods (then at a low level), fixed capital equipment, on this basis, may have been worth between £15,000 and £20,000 million. Perhaps we should take £17,500 million as a mean figure, although most people suspect that this is rather too low.

Now we know from our old friend, the national income blue book for 1952, that the replacement cost of capital equipment rose by just over 53 per cent in the six years from 1946 to 1952; if we cock this up to 60 per cent to allow for the rise between 1945 and 1946, that means that the £17,500 million of capital equipment which we postulated as existing at the end of 1945 may have been worth about £28,000 million at the end of 1952. But was this fixed capital added to between 1945 and 1952, or did more of it wear out than was replaced?

Gross expenditure on fixed capital formation in the seven years 1946 through 1952 amounted to just over £10,500 million at current prices and to just under £13,000 million in terms of 1952 market prices; that comes out at an average annual fixed investment (in terms of 1952 prices) of about £1,850 million, which may be compared with an actual expenditure of £2,050 million in 1952 itself. But how fast was capital equipment wearing out over this period?

It used to be a popular statistical exercise to try to assess the wear and tear on existing capital assets by adding up the total of depreciation allowances permitted by the Inland Revenue. There are three reasons why it is nonsense to use any such yardsticks now. First, these allowances are computed on the basis of historical costs – that is to say, a factory built in the 1930s will still only be drawing depreciation allowance in terms of £s of the 1930s not of the £s of today. Secondly, the Inland Revenue has varied its method of making depreciation allowances in recent years, particularly in respect of the amount that it allows in the first year of the equipment's construction or installation. Thirdly, there are large classes of fixed capital equipment – for example, all private dwelling houses, non-industrial buildings such as offices and shops, all buildings belonging to non-profit-making organizations, and most of the fixed assets of the central Government – that do not qualify for ordinary depreciation allowances at all.

In trying to assess true depreciation today, therefore, the analyst has only very thin clues to work upon. First, a very

TABLE I

ESTIMATED NATIONAL PRODUCTIVE CAPITAL OF THE UNITED KINGDOM

(£ millions at current prices)

	End 1945	*End* 1952	*Increase* 1945–52		
			Due to price increases	*Due to net investment*	*Total*
Net overseas investments .	Nil	Nil	at least +50	−50	Nil
Stocks and work-in-progress .	4,000	7,300	+2,700	+600	+3,300
Fixed capital Equipment .	17,500	32,000 to 35,000	+10,500	+4,000 to 7,000	+14,500 to 17,500
Total . .	21,500	39,000 to 42,000	+13,500	+4,500 to 7,500	+18,000 to 21,000

tentative estimate does exist that true depreciation in 1938 amounted to some £450 million; this estimate, which is more likely to be an underestimate than an overestimate, was based mainly on depreciation allowances granted in that year plus notional assessments for deterioration of capital that did not qualify for such allowances. Between 1938 and 1952 replacement costs of capital equipment seem to have risen by somewhere between 170 and 200 per cent; if average total capital equipment existing between 1945 and 1952 was not very different from that existing in 1938, this would suggest average annual depreciation in these years (in terms of 1952 prices) at between £1,220 and £1,350 million. If we choose a mean figure of about £1,300 million, this would suggest that Britain has added to its fixed capital equipment at a rate of about £550 million a year (i.e. £1,850 million *minus* £1,300 million) between 1945 and 1952. This would give us a total of some £3,850 million of new net fixed investment in these seven years. It would put the real replacement cost of Britain's fixed capital equipment at the end of 1952 at just under £32,000 million.

There are two reasons, however, for supposing that this estimate may be too low. In the first place, the new equipment that Britain has been installing has not merely replaced the old equipment; it has been better than it. Secondly, in trying to assess wear and tear, the analyst often falls into too glib an assumption that after a given period of years equipment that is not replaced falls into literally total disuse. The statistical devices – or guesses – needed to correct these assumptions are very complex, and all that need to be said here is that the estimate of £3,850 million as net fixed investment between 1945–52 seems to be a minimum estimate; on certain other assumptions it is possible to arrive at an estimate of around £7,000 million.

If these rough guesses are near to being right, therefore – as Table I shows – the value of the national productive capital of Britain may have been around £40,000 million at the end of 1952; and the average net annual addition to that capital in the seven years preceding, but in terms of constant 1952 prices, may have been between about £650 and £1,100 million a year (including £100 million a year of new investment in working capital). This suggests that we may be adding to our real capital stock at a rate of about 2 per cent a year; this is almost certainly below the current rate in such countries as the United States, Canada, Western Germany, Russia and (proportionate to their lower starting point) Japan. In the following chapters we will discuss who is doing the saving necessary to keep up this rate of capital accumulation in Britain, and how these savings find their way into productive investment; and we will then go on to delve into the question of by whom and how all this capital is owned.

CHAPTER III

THE PATTERN OF SAVINGS

Any study of the mechanism of the flow of savings into and out of the capital market must begin with an examination of exactly who are its customers – that is, who are the savers and borrowers – and of what instruments they can use. For our purposes in this book, it is convenient to divide savers and borrowers into five groups: persons, companies, the nationalized industries, local government authorities, and the central Government.

Table II takes 1952 as a sample year and shows how the £2,272 million of gross savings in that year were divided between these five classes; the figures are taken from the official national income blue book for 1952, but they are necessarily subject to a wide margin of error (in fact, each year's official estimates are regularly revised when the subsequent year's blue book comes out). According to this particular blue book, the main components of savings in 1952 were:

£502 million of personal savings;
£1,045 million of undistributed company profits;
£125 million of undistributed profits of the nationalized industries;
£76 million of surpluses in the current budgets of local authorities;
and £337 million of surpluses in the current budget of the central Government.

With a residual error of £15 million, these add up to a grand total of £2,100 million.

To these, however, must be added two other items that make their marks upon the capital accounts of the various sectors. First persons, companies and the nationalized industries had incurred £154 million of net new obligations to tax collectors or shareholders which they had not paid over at the end of 1952; there can be some argument about whose savings these were, but we have treated them under the non-commital heading 'borrowing from tax and dividend reserves'. Secondly, savings as defined here are equal to current incomes minus current consumption; and they are struck before taking account of capital transfers. Most capital transfers are internal transactions within Britain; for example, payments out of accumulated private wealth to the Inland Revenue in settlement of death duties are regarded as a capital transfer from persons to the Government. But, in addition, Britain received £18 million net of capital transfers from abroad in 1952. This £18 million can justly be added to the £2,100 million of direct savings and the £154 million of savings in the limbo of tax and dividend reserves, to make a grand total of £2,272 million of available investible funds in Britain in 1952.

TABLE II

THE FINANCE OF INVESTMENT, 1952

(£ millions)

	Persons	*Companies*	*Nationalized industries*	*Local authorities*	*Central govt.*	*Total*
Savings . .	502	1,045	125	76	337	2,100*
Capital transfers (net) . .	−95	+24	+5	+12	+72	+18
Borrowing from tax and dividend reserves . .	−50	+187	+17	—	—	+154
Gross funds available for investment . .	357	1,256	147	88	409	2,272*
Replacement of stocks at higher prices . .	58	23	1	—	−32	50
Stock piling .	−45	−187	34	—	75	−123
Fixed investment .	295	631	410	521	197	2,054
Gross domestic investment . .	308	467	445	521	240	1,981
Available for lending to other sectors . .	+49	+789	−298	−433	+169	+291*
(Average annual amount available for lending 1948–51)	(−312)	(+257)	(−188)	(−304)	(+649)	(+95)†

* Including residual error of £15 m.
† Including residual error of −£7 m.

Funds that are available for investment by any person or organization can be used in two main ways. First, they can be used for real investment – that is, for the purchase of machinery or other capital equipment, for making additions to stocks or for replacing stocks at higher prices; the table shows how the £1,981 million of real investment in Britain in 1952 was divided between these different forms and these different sectors. Secondly, they can be used by the savers (whether persons or organizations) for lending to other persons or organizations through the capital market. Table II shows that in 1952 three groups – persons (£49 million), companies (£789 million) and the central Government (£169 million) – had net sums available for lending on the capital market in this way; while the nationalized industries and the local authorities had to be heavy net borrowers. The figures in parentheses at the bottom of the table make it clear, however, that persons have not usually had net funds available for lending in this way since the war; in each of the years from 1948–51, in fact, only the central Government and companies were net lenders on the capital market.

Before turning to examine in detail how real investment is undertaken and how available funds can be lent on the capital market, it is worth emphasizing that the net total of the different sectors' available loanable funds in any one year (i.e. £291 million in 1952) is necessarily equal to the difference between the nation's gross investible funds and gross real domestic investment (i.e. £2,272 million *minus* £1,981 million in 1952). Another way of saying this is that the country spent, on consumption and real investment combined, £291 million less than it earned in 1952; in consequence it had a balance of payments surplus of £291 million in that year. But in 1948–51, as the table also shows, Britain's average annual balance of payments surplus was only £95 million. Moreover, this 'surplus' is struck after taking credit for gifts from the Americans averaging some £120 million a year; in reality in this period, as also in 1946 and 1947, we were in deficit.

There is a danger that the reader may have felt swamped by the flood of figures in this short chapter. But the chapter has had three main objects. The first has been to emphasize the point that when a person or organization saves, he or it can use those new savings in one of two ways: either for adding to his or its own existing real property ('direct real investment'), or else for lending to other persons or organizations through the capital market. For example, when a dentist uses some of his current income to buy a new dentist's chair to improve the productivity of his business, he is saving in the sense in which economists use that term just as much as if he put the money concerned into his bank deposit (thus enabling the bank to lend more on the capital market).

The second object has been to set down in Table II how much money persons, companies and other sectors saved in our sample year, 1952; together with how much money they used for new direct real investment and how much they had available for lending (or how much they had to borrow) on the capital market in that year. It would be a great mistake for any eager beaver to try to learn the figures in Table II by heart, for the table only refers to one particular year; but since a sample is needed for our analysis, it has seemed wisest to take an actual sample rather than just make the figures up. We will be returning to this Table II several times in this book, and that is why we have been rather finicky in explaining how the different figures in it have been arrived at.

The third object of the chapter has been to emphasize that the amount of real investment (that is to say, the amount of provision for the future) that the country can undertake must necessarily be equal to its total savings – except in the very short term, when some of its domestic real investment can be financed by borrowing from abroad (that is to say, by running a balance of payments deficit). If the reader bears these three main points in mind – that a saver can use his savings either for direct real investment (e.g. buying a tool of his trade or some other piece of productive equipment) or else for some form of lending on the capital market; that savings can most easily be classified as arising in one of the five sectors delineated in Table II; and that if real domestic investment exceeds domestic savings the country runs a balance of payments deficit – then he can go on to the next chapter in the full swim of the argument.

CHAPTER IV

WHO SAVES AND WHO BORROWS?

I. PERSONS

We can now turn to look in detail at the savings and investment habits of the first of our five groups, namely persons. There are about 50 million persons in Britain at the moment of whom over 20 million are wage or salary earners and perhaps 1½ million work in businesses that they own themselves. The rest are nearly all either housewives or people too old or too young to work. There are very few drones of working age left in Britain today.

The total capital in the hands of these 50 million persons in Britain today can be tentatively estimated at between £30,000 million and £35,000 million.[1] Some of this personal capital is held in the form of real property arising from direct real investment in the past – for example, the assets of small businesses and house property; and some of it is held in the form of bank deposits or securities or other assets that we can regard as forms of personal lending through the capital market. When a person saves, he adds to one or other of these different types of assets. What, in detail, are the different types of assets involved? What is their relative importance, and, therefore, in what directions have personal savings been directed in the past?

In Table III below we show the proportions in which all estates assessed for death duties in 1950–1 were held as between a number of different forms of property – and then, in the next column, the total value of such forms of property that would be revealed if total personal capital amounted to £30,000 million and if it is assumed that it was distributed between different property forms in the same way as the capital assessed for death duties. Of course this is not an accurate assumption, because the death duty figures do not give us a proper sample of property holdings for the population at large. The biggest snag and distorting factor is that only estates of over £2,000 are now assessed for death duties, so that about 85 or 90 per cent of the population (who do not have fortunes as high as £2,000) do not appear in this valuation when they die. The poorer 85 or 90 per cent of the population probably does not own much more than 10 or 20 per cent of total private property, but it does of course own much more than 10 or 20 per cent of certain types of property (such as household goods and currency notes and deposits in the Post Office Savings Bank). This must cause a considerable distortion in our figures, even if the basic assumption that total private property is worth around £30,000 million is approximately correct (which is by no means certain). But we can consider some of these difficulties as we come to them; and meanwhile Table III will permit us some introduction to the ways in which individuals can invest their savings.

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[1] This estimate can be derived by using the figures of estates assessed for death duties as a random sample and drawing appropriate deductions for the country as a whole after study of the net mortality rates in each age group. For detailed statistical exercises of this kind see articles by Kathleen Langley in the *Bulletin* of the Oxford Institute of Statistics, December 1950 and February 1951. There are three main reasons why the total capital owned by British persons is not equal to the total capital owned by Britain as a whole (which we estimated at around £40,000 million in Chapter II): (*a*) Some buildings and other assets are owned by the Government or by corporate and institutional entities not belonging to persons; (*b*) the assets owned by companies are often more valuable than the market value of shares in these companies owned by persons; but (*c*) some of the Government securities owned by persons – and rightly included in assessments of personal wealth – have no real assets behind them (they may represent money lent to the Government to pay for the manufacture of munitions blown off at the enemy in past wars).

It will be seen that we have grouped the items in Table III under four main heads:

(1) Real property;
(2) Liquid assets;
(3) Stock exchange and other variable price securities; and
(4) Other credits and debts.

We can pass fairly lightly over the first and last of these groups, and thereafter concentrate most of our attention on the second and third.

The group 'real property' comprises all the past savings that persons have directed into direct real investment – that is to say, into buying their houses and things put into them, into buying real assets for their own small businesses, and so on. As far as can be seen, about a quarter of all personal property is held in this way. The other three-quarters of personal property is held in the form of pieces of paper which show that the past savings concerned have been lent out on the capital market.

We will have to pass fairly hastily here over the fourth of our

TABLE III

HOW PERSONS MAY HOLD THEIR CAPITAL

Held in	*Per cent of gross capital*	*Total holdings of persons in £ million on assumptions stated*[1]	*Outside estimate of personal holdings in £ million*
Real property			
1. Land, houses, business assets, household goods and other property	25	7,900	—
Liquid assets			
2. Cash	0.1	*negligible*	—
3. Bank deposits	12	3,700	5,500
4. Shares and deposits in building societies, etc.	4	1,300	1,400
5. National savings certificates and defence bonds.			2,500
Stock Exchange and other variable price securities			
6. British Government securities	18[2]	5,700[2]	—
7. British industrial and municipal securities	28.5	9,000	—
8. Overseas securities	3.5	1,100	—
Other credits and debts			
9. Insurance policies and sundry debts owing	9	2,800	—
10. Sundry debts owed	—5	—1,500	—
Total	(100 — 5)	30,000	—

[1] i.e. on assumption that total net personal capital is £30,000 million and that it is divided as in death duties' sample for 1950–51.

[2] National savings certificates and defence bonds are not separated from other British Government securities in the death duties figures.

groups, namely 'Other credits and debts'. The 'debts' part is obvious enough: money owed on the mortgage of one's house, to banks and so on. The credits comprise odd debts owing to the deceased, sundry pieces of property that are not classifiable under any of the other heads used here, and – very important – insurance policies. We will see later in this book that saving through insurance premiums is probably the most important form of new personal saving in Britain today; and that the new money that the insurance companies gather in is re-lent by them in very large amounts to British industry through the new issue market and elsewhere. As soon as the young married man has some surplus of income over immediate consumption needs, he usually starts to save through insurance premiums as a protection for his family, his old age or (rather morbidly) to pay for his eventual funeral. Unfortunately, however, these death duty figures are a very poor guide to insurance figures, and for an obvious reason. Our sample shows figures struck at time of death, and a life insurance policy is one asset that has a very different value at time of death from its surrender value during the owner's lifetime.

We can now turn to the two most important of our groups; and, as we do so, some people will say that we are at last cutting the cackle part of this book and coming down to look at the City of London in real earnest.

When an individual saves some of his income and does not wish to devote it to saving through life insurance or to adding to his real personal assets, he can devote it instead to holding certain pieces of paper or book credits in which the City of London deals. When he makes such a decision, he has a straight choice between holding pieces of paper or book credits that do not fluctuate in money value (these we have called 'liquid assets'); or else to take a gamble and hold pieces of paper that do fluctuate in money value ('variable price securities') but that will hold out to him the eventual hope of some capital gains and the immediate hope of a higher investment income than he could get by holding liquid assets.

Persons' Holdings of Liquid Assets

The principal forms of liquid assets are:

(1) Bank notes and currency;
(2) Deposits at savings banks and commercial banks;
(3) Shares and deposits in building societies;
(4) National savings certificates and defence bonds.

Some people would add to this list shares of co-operative societies (of which there are between £200 and £250 million outstanding); and we shall see later in this book that there are also substantial quantities of other liquid assets (mostly short-term Government securities, such as Treasury bills and Tax reserve certificates) that are of interest to business concerns but not of so much import to individuals. But, while we are discussing the main opportunities before personal investors, this list is long enough.

The most liquid of all forms of assets are, of course, *bank notes and currency*. Average annual currency circulation outside the banks in the first seven post-war years ranged between £1,230 million and £1,400 million. We shall discuss later, in Chapter XVI, where this might be held; but, of course, it is immediately obvious that much more than the 0.1 per cent of personal assets (or about £30 million) shown in the table must be held by private individuals at any one time. The very low figure in the table is explained partly by the fact that the 85 or 90 per cent of the population that does not enter into the death duty figures probably hold between them four or five times as much cash as the 10 or 15 per cent who do (not between one-tenth and one-fifth as is implicitly assumed in the general calculations underlying Table III); and presumably partly by the fact that when Grandpa dies the notes in his wallet are not always left there until the estates duty assessor comes round. The problem of how much cash is held by persons cannot therefore easily be discussed here. In any case, changes in cash holdings tend to have a fairly close connection with changes in wages and prices – rather than with changes in saving. People who are able to save (and those who have some past savings to live off) try to hold enough cash to finance their spending in the next week or so without the bother of too frequent visits to the banks. A few people may hold their fortunes in cash rather than in interest-earning securities, especially if they think this is a way of hiding earnings that have not been disclosed to the income tax inspector; but this trait is possibly less characteristic of the British than of the inhabitants of some other European countries. There is not much more than this in any examination of the question of why people tend to hold more or less of their savings in the form of currency or notes.

The next most liquid form of savings is, of course, through additions to *bank deposits*. At this writing (late 1953) it is possible to trace some £3,000 million of deposits in the Post Office, trustee and other savings banks; most of these banks at present offer interest on deposits at 2½ per cent, but depositors are supposed to pay income tax on this. At the same time deposits at commercial banks (Lloyds, Midland, Barclays and so on) are around £6,500 million; in a memorandum to the Royal Commission on Taxation in 1951, the British Bankers' Association suggested that rather less than 40 per cent of all 'deposits less advances' were owned by persons and rather more than 60 per cent by business concerns. This could be read to suggest that total personal deposits at the commercial banks should be around £2,500 million: with savings bank deposits of £3,000 million, this would put personal bank deposits of all kinds at £5,500 million, which is £1,800 million more than the total shown in the second column of Table III. Apart from the shakiness of our estimate of £30,000 million for total personal capital, there are two possible explanations of this discrepancy. One is that the British Bankers' Association's definition of personal deposits may include some deposits that the estates duty people would sweep into business assets. The second and more important is that the poorer nine-tenths of the community (in terms of capital not income) may hold somewhere between 40 and 50 per cent of all savings bank deposits; if so, the general calculations underlying Table III (which assume low holdings for this group) could have 'lost' about £1,000 million of their deposits.

For those who are trying to trace the ownership of different forms of liquid assets, there is an important 'class distinction' between savings bank deposits and commercial bank deposits. In a very valuable sample survey of personal incomes and savings in 1952[1] the Oxford University Institute of Statistics suggested that about one out of every three income units in Britain has a deposit at the Post Office Savings Bank (with a mean holding just below £120) but that only about one in six has a deposit at a joint stock bank (with a mean holding of around £400). Moreover, it suggested that the richest one-tenth of 'income units' (ranked according to total liquid asset holdings) held about 85 per cent of all commercial bank deposits but only 52 per cent of all Post Office Savings Bank deposits. It seems clear from these figures that the savings banks can lay some claim to being the small man's media; it is probable that not much money is withdrawn from these accounts for transfer into stock exchange securities, although some has certainly been withdrawn in recent years for transfer into national savings certificates and building society shares (which offer virtually the same capital security and – at the moment – also a tax-free yield that is higher than the taxed yield on savings bank deposits).

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[1] See *National Survey of Personal Incomes and Savings*, by H F. Lydall. *Bulletin* of the Oxford University Institute of Statistics. November–December 1952, February–March 1953, and June–July 1953. Mr Lydall used the term 'income unit' for (*a*) any single person over 18; (*b*) any married couple, with its children attached. The 50 million people in Britain are split into 22 million income units, but 14½ million households.

Against this, however, commercial bank deposits are still the province of the richest one-sixth of the community; and it is an extraordinary fact that the Oxford survey showed that the average commercial bank deposits of those who earned more than £1,000 gross a year was nearly £1,200 (although admittedly this average came down to some £660 when those large holders of bank deposits – the farmers – were excluded). Deposits of this size are much bigger than most people can need as an idle (and either non-interest-bearing or low-interest-bearing) cash balance.[1] Commercial bank deposits must therefore be regarded as the main pool of liquidity that sends eddies out into the stock markets. When confidence ebbs and flows on the Stock Exchange – and prices ebb and flow with it – it is probably often because people are either selling securities in order to 'go liquid' by adding to their commercial bank deposits, or else buying securities with money transferred out of these deposits. Of course when one person buys a stock exchange security from another he does not cause any change in the total level of deposits; his own deposit only goes down by as much as the seller's deposit goes up. But the trend of stock market prices is largely dependent on whether there are more people who are actively seeking to buy securities than there are people who are actively trying to sell and 'go liquid'. It is a fair conclusion from the figures cited here that there must be around £1,000 million of personal deposits in commercial banks that are surplus to cash requirements as such, which shows what a large 'tail' of liquid assets exists ready to wag the Stock Exchange 'dog'. These figures can find some rough confirmation from the fact that the average bank deposit of those with estates between £50,000 and £60,000 assessed for death duties in 1950–1 was around £5,500; as an extreme case the average deposit of the eight millionaires who died in that year was apparently around £250,000. This picture – of a very large reserve of potential investible funds among the rich but a very small one among the poor – will deserve to be remembered later in this book, when we come on to discussion of stock exchange trends.

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[1] Current account deposits at commercial banks – which can be drawn on by cheque at any time – do not earn interest for the depositor at all. Deposit accounts – for which notice of withdrawal must be given – have carried between ½ and 2 per cent interest at various times since the war.

The next types of liquid asset to be considered are shares and deposits with *building societies*. At present (late 1953) with a 3½ per cent Bank Rate, most building societies pay out 2½ per cent tax free on their shares and 2 per cent on their deposits. The only 'risk' on this type of investment is that the society chosen may go bankrupt; this is exceedingly unlikely in most cases, so that it is not surprising that the building societies have been attracting funds away from the savings banks (who have been paying out 2½ per cent subject to tax in the first seven post-war years). Building society funds have in fact been increasing at around or over £100 million a year in recent years. There were just under £1,400 million of building society shares and deposits outstanding in early 1953, so that the figure of £1,300 million shown in the second column of Table III fits in fairly well with the available evidence (even though the form in which the death duties figures are drawn up suggests that this latter figure may include a small amount of money lent out on personal bonds).

The final types of liquid assets to be considered – by liquid assets, be it remembered, we mean assets that do not fluctuate in money value – are *national savings certificates and defence bonds*. The interest on national savings certificates (it is 3 per cent on the latest issue at the time this is written) is free of tax; but people are only allowed to hold a certain number of them (usually up to £500 on each issue). They are thus meant to be the small man's media, although of course surtax payers usually hold as many of them as they are allowed to because the tax-free yield is very attractive. Defence bonds (the latest issue of which bears 3½ per cent interest, but subject to tax) are less attractive; they are often bought by people who want to hold a Government security that will not fluctuate in price, but who have already bought all the national savings certificates that they are allowed to hold.

At the end of March 1953 there were around £1,750 million of national savings certificates and just over £800 million of defence bonds in issue. Both savings certificates and defence bonds are

Government securities and they are not shown separately in the death duties statistics; if all of the £2,550 million of them are included in the £5,700 million shown for total Government securities in the second column of Table III, that would suggest that just over £3,000 million of other British Government securities (mostly Government securities quoted on the Stock Exchange or 'gilt-edged' as they are called) were held by persons. Actually, because a large number of national savings certificates are held by people who are too poor to enter into the death duties statistics, personal holdings of gilt-edged are probably rather higher. About £3,500 million may be a reasonable figure.

Variable Price Securities

We come now to securities that are variable in price[1]. If the estimates we have made above and in the second column of Table III are approximately accurate then persons may hold something over £13,500 million (or about 45 per cent of their total capital) in variable price securities. These would be divided as between £9,000 million in British industrial and municipal securities, around £3,500 million in British Government securities ('gilt-edged'), and around £1,100 million in overseas securities (especially securities of governments and businesses in the overseas Commonwealth). These, of course, are very rough estimates indeed. But published information about security holdings is so scanty that it has seemed worth-while to set down these figures here.

These £13,500 million odd of variable price securities consist partly of securities that are quoted on the London Stock Exchange, and partly of securities that are not quoted there. (Often, because they are securities of small private companies or for other reasons.) We shall try to analyse their distribution between these two classes later in this book, when we will enter upon the problems of stock exchange investment in full earnest. But before doing so there is a very important point about the distribution of these variable price securities as between wealth

[1] Because variable price securities are risky things to hold, the income yield on them naturally has to be higher than that on liquid assets. This yield varies as prices vary. At mid-1953 – a convenient date to take to compare with other interest rates quoted above – the following were representative yields available in the London Stock Exchange: On long-term gilt-edged 4⅛ per cent; on first-class industrial debentures 4⅝ per cent; and on first-class industrial ordinary shares 6½ per cent. We will discuss the difference between these different types of security in later chapters.

groups that needs to be noted. Table IV below shows how total variable price securities assessed for death duties in 1950–1 were divided in this way.

The most striking fact that emerges is that some 49 per cent of all joint stock companies' shares assessed were held in estates of over £50,000, compared with 31 per cent of all British Government securities assessed and 44 per cent of 'other Government and Municipal securities'. The amount of industrial securities held in estates that escape assessment from death duties (i.e. those below £2,000) must be comparatively small; and some of the stocks and shares in the lower wealth groups will be co-operative society shares, and so on. It is therefore probably legitimate to conclude from these figures that somewhere around one-half of all industrial securities are in fact held by people with £50,000 and more. The death duties statistics have shown this pattern consistently over a run of years. It is unfortunately true that most personal holdings of stock exchange securities – especially industrial securities – are held by the rich.

TABLE IV

SECURITY HOLDINGS ASSESSED FOR DEATH DUTIES 1950–1

Percentage held in estates in range:	*British Government securities*	*Other government and municipal securities*	*Stocks, shares, etc. of joint-stock, etc. companies*
£2,000–£10,000 .	30	14	13
£10,000–£20,000 .	18	16	14
£20,000–£50,000 .	21	26	24
£50,000–£100,000 .	12	16	16
Over £100,000 . .	19	28	33
Total . .	100	100	100

The importance of this statistic lies, of course, in the facts that practically nobody can be building up a fortune of over £50,000 from scratch today; and that when existing fortunes of over £50,000 – there may still be around 50,000 of them – come under the hammer of death duties they are mulcted to the extent of 35 per cent (rising to the extent of around 80 per cent for Britain's two hundred or so millionaires). The fact that practically nobody can be building up a fortune of over £50,000 from scratch today can be deduced from Table V, which shows that only 60 people in the whole country were making over £6,000 a year after tax in 1949–50. To this must be added the fact that when assets have to be sold out of estates to meet death duties, stock exchange securities – and especially industrial shares – naturally tend to be sold first.

Unequal Wealth, but Equal Incomes

We must now look into this question of the slowly disappearing rich – and of the effect of their slow disappearance upon the capital market – in more detail. There is no doubt that the private wealth that has been inherited from the past is still very unequally divided. Analysis of both the death duty figures (which used to take note of all estates above £100 up to 1945–46) and the taxation authorities' figures for investment income makes some very rough estimates possible. We can divide the total population into three groups:

(1) There are not likely to be more than about 1,000,000 people (or 2 per cent of the total population) with fortunes of over £5,000 in the United Kingdom, and these 1,000,000 people probably own nearly £20,000 million between them (or, say, rather over 60 per cent of all private wealth).

(2) There may be about another 10 million people with fortunes between £100 and £5,000, and they probably own about £10,000 million between them (or, say, rather over 30 per cent of all private wealth).

(3) That leaves nearly 40 million people (or 80 per cent of the population) with net accumulated savings that are probably below £100; even if they hold an average of £50 each (which seems improbably high) they will only hold about £2,000 million, or considerably less than 10 per cent of all private wealth.

Admittedly, these rough figures are not quite as indicative of inequality as some politicians sometimes make them sound. The bottom 80 per cent will include much less than 80 per cent of all heads of households; and many platform speakers forget that they are including some millionaires' children and some rich men's property-less wives among their assumed mass of poor. Perhaps a fairer picture may be found by comparing the 11 million odd people who seem to own accumulated savings above £100 with the 14½ million odd households in Britain. But the dominant fact – that comparatively few people own a comparatively large proportion of private property – remains. A few individual savings media are fairly widely spread; it is probable that over 10 million different people have some stake – albeit many of them only a very small one – in the £5,500 million odd of 'national savings' (i.e. savings bank deposits, national savings certificates, and defence bonds) outstanding. It is also believed that over 3½ million people in Britain own their own homes, although over 1½ million will have mortgage debts outstanding on those homes. But, at the bottom of the scale, it is unlikely that more than about 1½ million British families have a stake in the £13,500 million of stock exchange and other variable price securities which – we have suggested – are in private hands.

In contrast to this inequality of accumulated or inherited wealth, the distribution of current incomes is very equal indeed. This means that the distribution of accumulated wealth will gradually become more equal too – although only after a time lag. Table V below – which is drawn from Inland Revenue figures – shows the distribution of after-tax incomes in 1949–50; the total of these incomes (£7,202 million) is about £1,500 million short of known net personal incomes in that year, but none (or, at least, very few) of the missing millions will be millions received by the rich. It will be seen that the 19½ million odd people with after-tax incomes below £1,000 deployed nearly £6,500 million or just under 90 per cent of net annual income between them; the 400,000 odd with net incomes

TABLE V

ESTIMATED DISTRIBUTION OF INCOMES IN BRITAIN AFTER TAX 1949–50

Range of Net Income	*Number of Incomes*	*Total Income after Tax*	
		£ million	*Per Cent of Total*
£135– £150	1,021,000	147	2
£150– £250	6,626,000	1,334	18½
£250– £500	9,470,000	3,350	46½
£500–£1,000	2,460,000	1,608	22
£1,000–£2,000	384,760	523	7½
£2,000–£4,000	83,170	218	3
£4,000–£6,000	5,010	22	Negligible
Over £6,000	60	0.5	Negligible
	20,050,000	7,202	100

between £1,000 and £2,000 deployed only just over £500 million of net annual income; and the 90,000 odd with net incomes above £2,000 deployed less than £250 million. Finally, at the very top, only 60 people in the entire country had after-tax incomes over £6,000 a year in 1949–50: they would each have had to earn a gross income of over £60,000 to secure this – in other words they were allowed to keep, at most, 2*s* out of every £1 they earned. The equalization of incomes that has been achieved in this country can best be exemplified by this last statistic; and also by the fact that if all incomes over £4,000 a year net were completely confiscated, this confiscation would bring in the Exchequer considerably less than the revenue needed to cut even 1*d* per pint off the tax on beer.

Inevitably, this post-war equalization of incomes must be expected to carry with it grave problems for the capital market. Two such problems stand out. The first is that of the inadequacy of personal savings as a whole; generally speaking a country where a few rich people have a lot more than they need is likely to have a high rate of personal savings, and a country where incomes are more evenly distributed will naturally tend to spend most of what it earns. This is, in fact, what has been happening in Britain since the war. Table II, back on page 26, showed the original official estimate of personal savings in 1952 to be £502 million; this was equal to some 4 per cent (or say 9*d* in the £) of personal incomes. There is evidence that this official estimate was too low, and the latest estimate of the personal savings rate in Britain (for 1953) is about 1*s* 4*d* in the £ of personal incomes. Nevertheless the total of savings needed to finance Britain's – probably inadequate – rate of total internal investment in recent years has been around 3*s* in the £ (or 15 per cent) of gross national income. It is therefore at once obvious that the larger the proportion of total income that gets through to persons the smaller are the country's chances of financing the internal investment it needs without running into a balance of payments deficit. This was even more strikingly apparent in the early post-war years; in 1948, for example, persons are estimated to have saved only 2½*d* of every £ of their income.

The second problem that arises from the levelling of personal incomes concerns the even graver shortage of particular *types* of savings that used to be mainly a preserve of the rich. The most important type of saving by the rich, as we have seen above, is that which used to find its way into risk securities on the Stock Exchange. Our old friend, Table II on page 26, suggested that the amount that persons had 'available for lending to other sectors' – after allowing for direct personal real investment (in new houses, small private businesses and so on) and for capital transfers to meet death duties – was just under £50 million; the savings estimate on which this figure was based may have been too small by some £250 million, but Table II also showed us that in the years immediately before 1952 the amount that persons had 'available for lending to other sectors' was actually a substantial minus quantity. Yet we know that those sectors of the capital market that customarily draw the small man's funds have been showing net accretions in recent years. Personal saving through life insurance (including home service or 'industrial' insurance) has recently averaged about £170 million a year; shares and deposits held in building societies have recently been rising by about £100 million a year (though this, admittedly, has largely been offset by personal borrowings on mortgage from these societies); the total funds invested in the national savings movement have recently been rising slightly; and there has certainly been some net personal saving in the form of contributions to various private pensions schemes. All these add up to perhaps £300 million a year. This suggests that in some past years at least, the amount of new personal savings coming onto the Stock Exchange must have been a minus quantity. Persons must have been selling more Stock Exchange securities than they have been buying.

Here, then, is one of the most important factors about the capital market today. Our analysis has suggested that between 40 and 45 per cent of total personal capital today may be held in the form of variable price securities – and about 30 to 35 per cent in the form of especially risky (i.e. non-British Government) variable price securities. But it has also suggested that there may be a grave dearth of people of the type that are able and willing to invest in variable price securities under present taxation conditions. We saw in Chapter I that one of the main reasons why Britain enjoys a higher standard of living than most other countries today was that it had for long possessed an excellent mechanism for transferring savings 'from the hands of the men who have saved into the hands of businesses that are able and eager to use savings to good advantage'. The alarming conclusion, which seems to emerge from the above analysis, is that the direct transfer of savings from persons to businesses through the medium of risk securities may be drying up. The grave question must therefore be faced: If personal savings are indeed disappearing as a source of net risk finance for industry, what is to replace them?

CHAPTER V

WHO SAVES AND WHO BORROWS?

II. COMPANIES AND NATIONALIZED INDUSTRIES

The second group of potential borrowers and savers to be considered is composed of the (to quote end – 1952 figures) 250,927 private companies and 11,587 public companies in Great Britain. Private companies are those with less than fifty shareholders, and whose articles restrict the right of transference of shares and prohibit invitations to the public to subscribe to them. At first sight, it seems fantastic that there should be over a quarter of a million small incorporated businesses of this kind; in view of the squeeze on small businesses since the war, it seems even more fantastic that their numbers grew by just over 100,000 between 1939 (when there were 147,000 registered private companies) and 1952. The explanation is, however, that present tax laws and the shortage of individual capital mean that it is usually much wiser now for a small concern to seek registration as a company than to stay as an individual business or partnership. Among the advantages of a private company over a partnership are that profits ploughed back into reserve need not attract surtax; that it may be easier for a company than for an unincorporated business to borrow from the banks because a floating charge can be allowed against a company's assets; that if a company goes bankrupt the owner's private fortune cannot be seized by his creditors; and that the death of a part-owner of a business that is not registered as a company can cause frightful legal difficulties for the surviving partners, especially in these days of high death duties. As one indication of this, it may be noted that some private companies that have secured registration since the war are of a very strange sort, like the attempt of professional sports stars to capitalize their names for advertisement purposes and individuals' transformation of their assets into so-called 'investment companies' (formed to minimize death duties).[1]

Similarly, some of the 11,587 public companies (i.e. companies that allow more than fifty shareholders and that may invite public subscriptions of capital) are not really significant business entities. The *Economist*, which makes strenuous efforts to analyse the balance sheets of all the genuine operating public companies it can find, traced 2,495 such balance sheets published in 1952. These 2,495 public companies had a total income (after paying wage bills and so on) of £1,701 million. The national income figures for 1952 showed that all companies in 1952 had a total income of £3,066 million,[1] so that the business operations of all the 250,000 odd private companies and of the 9,000 odd other public companies was apparently rather smaller than that of these 2,495 giants.

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[1] The best short economic textbook on company finance now available is F. W. Paish (1953) *Business Finance* (Pitman), 144 pp., price 12*s* 6*d*.

Now, to some extent, it is absurd to talk about 'companies' as a sector in the same way as we have talked about persons. All the assets of companies belong – either directly or indirectly through some other company as intermediary – to individual shareholders. The 'net wealth' of companies is therefore really nil. But as companies have paid out only a small proportion of their after-tax incomes in the form of dividends and interest to shareholders throughout the post-war years, and have kept back the rest to strengthen their savings or investment position without much more than a formal 'by your leave', it is much more sensible to regard them as a separate sector. Partly because of this under-distribution of profits, the market value of all assets owned by companies today is clearly much greater than the market value of their stocks and shares outstanding; this is one of the reasons why we found in the last chapter that persons' accumulated wealth (with their stocks and shares assessed at market value) was probably only about £30,000 to £35,000 million, or some £5,000 to £10,000 million less than the nation's accumulated wealth despite the fact that the large segment of persons' wealth that represents direct or indirect holdings of Government securities does not have fully equivalent real assets to back it up.

In order to start our analysis of companies as a separate sector we must look back to Table II on page 26 which showed how they financed their investment in 1952. Three points arise from a study of that table. The first is that the undistributed profits of companies amounted to £1,045 million in 1952, or about one-half of the nation's total savings in that year. This amounted to about 7*s* in the £ of companies' total income; more than 7*s* in the £ went in direct taxes paid by companies, and only between 5*s* and 6*s* in the £ on dividends and interest (which will have been taxed in their turn before they got to shareholders). So it is obvious that the bigger the proportion of national income that accrues in the form of company profits, the greater are the country's chances of securing the savings it needs to finance domestic investment without running into a balance of payments crisis. This is not a popular truth politically, but it is a truth all the same.

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[1] Income shown in balance sheets published in 1952 is not, of course, the same thing as income earned in 1952. Much of the income earned in 1952 makes its mark on balance sheets published in 1953, and the balance sheets published in 1952 include much income earned in 1951. But the broad picture shown by these statistics is fair enough.

The second point to notice from Table II is that companies undertook only about 23½ per cent of all investment and only about 31 per cent of all fixed investment in the country in 1952. As a very rough generalization, the bigger this proportion the better for Britain; real fixed investment that takes the form of additions to companies' productive equipment is more likely than anything else to expand the country's earning power in competitive world markets.

The third point to notice is that in 1952 companies had sufficient investible funds out of their own current savings to cover their new domestic investment in fixed capital and stocks, and with a lendable surplus of £789 million to boot; they have had some such surplus – though a smaller one – in most other post-war years.[1] There is, however, a catch about this. In the first place, many of these companies have world-wide trading interests, and they have to undertake some investment to replace or add to the equipment of their factories abroad; under the conventions used in Table II, this non-domestic investment would appear in the residual line 'available for lending to other sectors' (the 'other sector', in this case, being overseas countries). Secondly, some of the companies included in Table II were necessarily financial institutions whose main job was precisely this 'lending to other sectors'. When allowance is made for these two points, it seems that 1952 – a year when stocks of raw materials were drawn down – was the first post-war year when genuine industrial companies as a whole were able to cover their investment commitments out of their own savings. This surplus was repeated in 1953.

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[1] The years when they had not enough were usually the years when prices of raw materials, and thus the cost of stock replacement, increased substantially. A real difficulty arises here. If a company uses 3 lb of cotton in making a shirt, and if while it is making the shirt cotton rises by 2*d* a lb, the shirt's price should be raised by 6*d* to allow the cotton to be replaced. But (*a*) there is often a time lag between a rise in raw material prices and a rise in the price of finished products; and (*b*) if prices are raised, then the extra 6*d* cited in our example would be treated as an extra profit by the Inland Revenue, and mulcted of income and profits tax to the tune of 60 or 70 per cent. In either case the company has to borrow or draw into past savings to replace stocks.

Even in 1952 and 1953, however, some companies had obviously to be net borrowers while others had surplus savings to spare. In other words, companies had still to enter into the capital market as both borrowers and lenders. An introductory view of the way in which they borrow and lend can perhaps best be understood by examination of the composite balance sheet of the 2,495 public companies whose results, as already explained, were analysed by the *Economist* in 1952. This composite balance sheet, slightly simplified, is set down in Table VI.

It will be convenient to look first, at the assets side (that is, the right-hand side) of this balance sheet. The first item there is the £3,228 million of fixed capital assets. Most of these are entered at their original cost with allowance for wear and tear; comparatively few companies have written up their assets to equal replacement costs in line with the rise in prices, and most balance sheets therefore considerably understate the real value of these assets. This is a reflection of our familiar problem that a building, which cost, say, £10,000 or so to construct in 1935 is likely to be worth much more than £10,000 or so now, despite the fact that it has worn out a bit in the meantime. The second item, the £2,905 million of stocks, will be valued in this balance sheet much more nearly at genuine market prices; since stocks are turned over quickly, their market value is much easier to assess. The third and fourth items, 'debtors' and 'trade investments and intangibles', are something of a rag bag; they have their approximate counterparts among the items '"creditors"' and "minority interests, etc."' on the liabilities side of the balance sheet. They owe their existence to the facts that at any one time any company naturally has large bills owing to it, that public companies in Britain are often inter-locked with other companies through trade investments and minority interests, and that the goodwill attached to a trade name or reputation, or the value of patents, can justly be considered as valuable 'intangible' assets for any business.

TABLE VI

COMPOSITE BALANCE SHEETS OF 2,495 PUBLIC COMPANIES REPORTING IN 1952

(£ million)

Liabilities	*Total*	*Change from previous year*	*Assets*	*Total*	*Change from previous year*
Shares and debentures	3,526	+183	Fixed assets	3,228	+294
Reserves	3,208	+367	Stocks	2,905	+625
Bank overdrafts and loans	481	+139	Debtors	1,666	+199
Creditors and short-term liabilities	3,022	+390	Trade investments and intangibles	874	+10
Minority interests, etc.	282	+21	Cash and marketable securities	1,846	−29
Total	10,519	+1,100	Total	10,519	+1,100

That leaves us, as the last item on the assets side, with the £1,846 million of 'cash and marketable securities'. These are the companies' surplus liquid funds. They are held either in the form of deposits at the banks (which, of course, re-lend the money so deposited to their own borrowing customers) or else in securities that have been bought on the Stock Exchange. During the war, when companies were unable to plough back their profits into real investment and had to allow their equipment to rot away without replacement, there was, of course, a sharp increase in this item and especially in holdings of Government securities. In the first six post-war years, as a reflection of the fact that many companies were unable to cover their investment commitments out of their current savings, many of these securities had to be sold off; the banks, in particular, were pumping out funds to industrial companies both by buying gilt-edged securities from them and by extending new loans.

It may be noted, incidentally, that the memorandum presented in 1950 to the Royal Commission on Taxation by the British Bankers' Association suggested that smaller private companies were having to borrow and sell off securities even more heavily in the early post-war years than were the bigger public companies whose 1952 balance sheets are summarized in Table VI. In 1952 itself, as has already been noted, many companies had a surplus of new savings over investment commitments for the first time since the war; and in many cases these holdings of 'cash and marketable securities' therefore rose.

We can now turn to the items on the liabilities side of the balance sheet. The first of these is the £3,526 million of ordinary shares, preference shares and debentures. The differences between these three types of security will be discussed later in this book; very briefly, however, debenture owners and preference shareholders have a right to a fixed reward which has to be paid out before ordinary shareholders, who own the company, get a variable dividend according to whether business is prosperous or not. Since the 2,495 companies whose results are analysed in this balance sheet are the largest public companies in Britain, most of their shares and debentures will be quoted and dealt in on the London Stock Exchange. But the £3,526 million shown in the balance sheet does not represent the market value of these shares and debentures, but only a rather meaningless concept called their 'nominal value' instead. For example, to take a random example, Imperial Chemical Industries Ltd. has at this writing (in 1953) 70,651,162 ordinary shares in issue with a nominal value of £1 each; the figure entered against ordinary shares in its balance sheet is therefore £70,651,162. I.C.I. paid a dividend of 13 per cent on this nominal capital in 1952; but since people are willing to hold I.C.I. shares (at the moment) if they offer a yield of around $5\frac{3}{4}$ per cent, the market value of each £1 ordinary share of I.C.I. at the time this chapter is written is around $\frac{£1 \times 13}{5.75}$, that is about £2 5*s* each.

The entry against shares and debentures in any balance sheet will change either when the company raises new money on the Stock Exchange by making a new issue of shares and debentures, or when it makes what is somewhat misleadingly called a 'bonus' or 'scrip' issue (which is a pure book-keeping transaction). A new issue for cash will take place when the company is increasing its fixed investment at a greater rate than can be financed out of current profits. At first it may draw down its cash, sell off its marketable securities or borrow from the banks to undertake this fixed investment; but since any company needs some liquid reserves and since bank borrowing is meant to cover only part of working capital requirements (which usually means investment in stocks and does not mean investment in bricks, mortar or plant), really heavy new fixed investment will have to be financed in time out of the proceeds of a new issue on the Stock Exchange. The more prosperous the company and the bigger the dividends it has recently paid, of course, the more easily will it be able to float off such an issue.

A 'bonus' or 'scrip' issue is entirely different from an issue for cash. It arises simply when a company feels that the gap between the nominal and market value of its shares is misleadingly large; 'misleading', in this sense, often means open to misinterpretation by ignorant politicians, especially as dividends are usually expressed as a certain percentage (and therefore often an apparently high percentage) of nominal capital instead of as a lower but more intelligible percentage of market values. For example, in the case quoted in the last paragraph but one, Imperial Chemical Industries might decide to make a bonus or scrip issue to stockholders of one new £1 share for every £1 they held. If, at the same time, they announced that no change in the level of dividend payments would be made, all that would happen would be that a shareholder who previously held one £1 share worth £2 5*s* on the market, would now hold two £1 shares that were still worth £2 5*s* in all – or £1 2*s* 6*d* each. In I.C.I.'s balance sheet, meanwhile, £70,651,162 would have been switched from the heading 'reserves' to the heading shares and debentures; and its next dividend declaration for the full year would be 6½ per cent on a nominal capital of £141,302,324, instead of the previous 13 per cent on a nominal capital of £70,651,162.[1] The whole thing would be a book-keeping transaction without real significance.

The other items among the liabilities are reasonably self-explanatory. In most individual balance sheets the item reserves will be split into reserves held against specific contingencies – for example, replacement of fixed assets[2] or stock lines – on the one hand, and free reserves on the other; this has not been done in the simplified composite balance sheet in Table VI because the way in which individual companies choose to apportion reserves in this way – and to use the reserves once apportioned – is really rather arbitrary. The point to remember, however, is that these reserves are simply a book entry showing that £3,208 million of the companies' profits in the past have not been handed over to shareholders but have been used to build up the assets shown on the right-hand side of the balance sheet.

The other items among the liabilities do not need lengthy comment at this stage. It should be emphasized again, however, that bank overdrafts and loans are meant to be extended for short-term purposes only, and banks will not allow them to be used for long to pay for fixed capital investment. The item

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[1] As this book was on the point of going to press, I.C I. did in fact make just such a scrip issue of one new £1 share for every £1 share held. It occurred at a time when the old £1 shares had already moved up to 72 shillings under the spur of a rising profit trend. When the issue had been made the first price quoted for the £1 shares, as thus reconstituted, was just under 36 shillings

[2] This leads to discussion of another problem not unlike that discussed in the footnote to page 46 The wear and tear on existing capital equipment is, of course, a cost that is rightly deductible before assessing taxable profits. The Inland Revenue, however, never allows total wear and tear allowances on any one asset to exceed its original purchase price, so that the tax-free depreciation allowances on a machine bought in, say, 1913, can only mount up to the price of that machine in 1913, not to the cost of replacing it in the 1950s. The result is that company accounts traditionally show part of their costs (e g. the wage bill, etc.) in terms of current pounds and part (e.g. wear and tear allowances) in terms of pounds that may be of some pre-war vintage Most economists consider that this makes the accounts absurd – like an account that says 100 peas plus 3 cabbages equals 103 vegetables. But the tax collecting authorities and many eminent accountants – at any rate outside countries such as France, where pre-1913 francs quite obviously are not the same as post-1945 ones – have a different outlook on this

'creditors and short-term liabilities' also includes some bank finance (in the form of commercial bills, which will be discussed later in this book) and some impending tax liabilities as well as the companies' unpaid bills (the latter are a rough counterpart to 'debtors' on the assets side of the account). Incidentally, in the last thirty years or so, the item 'creditors' seems to have grown considerably in the balance sheets of companies; many more large companies now allow smaller businesses to buy goods from them 'on tick'. This is an important source of finance for small businesses today, although – as we shall see in Chapter IX – it can be a rather expensive one.

The Nationalized Industries

We may now turn to the place occupied in the capital market by the nationalized, as distinct from the private enterprise, industries. In its first period of post-war power, from 1945 to 1951, the Labour Government brought under nationalization the Bank of England, coal, transport, the airways corporations, electricity supply, gas supply, telecommunications, and iron and steel. There is no need to enter here into the widespread debate on the merit of these decisions, or on the varying fairness of the various methods of compensation used. Where possible the Government took over the shares and debentures held in these industries by private or institutional investors, and issued in return fixed interest stocks that were either direct obligations of the Government or (more usually) special Government-guaranteed nationalization stocks.

By the end of 1952, before the Conservative Government had put into effect its plans for de-nationalizing road transport and iron and steel, just over £2,150 million of such special nationalization stocks had been issued in exchange for previous private enterprise securities; annual interest payments on these amounted to over £60 million – a fixed sum that was guaranteed by the Government although it was, of course, a charge on the accounts of the nationalized industries themselves. Although the Government guaranteed the interest payments on these stocks, the actual market value of the stocks, of course, moved up and down just like those of any other stock exchange security. By early 1953, in fact, the market value of these compensation issues was only around 85 per cent of their nominal value of over £2,150 million.

One result of these issues was that a large segment (in fact about one-sixth) of the industrial shares and debentures quoted on the London Stock Exchange was converted into lower yielding but Government-guaranteed fixed interest stocks. This reduction in the supply of industrial securities and increase in the supply of gilt-edged securities happened to come at a time when there was also in train a reduction in demand for industrial securities (because of the strain on the rich private investor, to which reference has already been made) and an increase in the demand for gilt-edged (because, as we shall see later in this book, so large a share of current savings was piling up in the hands of financial institutions that need to hold at least part of their portfolios in less-risky securities). The large-scale nationalizations of these years, therefore, had the unforeseen consequence of covering up for a time the full scope of the risk capital crisis. Many of the private individuals, and some of the more risk-minded institutions, who received this compensation stock, sold it out to those institutions with a bias towards gilt-edged investment, and then went out to look for new risk securities themselves.

Another effect of the nationalizations was that the new publicly owned industries could raise new money for their investment programmes on the Stock Exchange by floating issues on gilt-edged terms, with Government guarantees and with the knowledge that large institutional investors (including especially, the Government-owned Bank of England and the National Debt Commissioners) would take up enough of their flotations to ensure success to the operation. The nationalized industries have naturally made full use of this facility; in fact in some recent years stock exchange new issues by the electricity, transport, gas and airways authorities have been larger than those made by the whole of private industry put together. The nationalized industries can also borrow on cheap and Government-guaranteed terms from the banks (somewhat to the banks' annoyance) and in some cases can also borrow direct from the Government itself; in addition, during the phase of steel nationalization, any surplus profits made by any one steel plant were lent at very low rates of interest to other steel plants in need of funds.

The result is, of course, that the nationalized industries have carried out very large real investment programmes indeed. As will be seen from Table II, back on page 26, the nationalized industries carried out about two-thirds as much fixed investment as companies in 1952 (£410 million against £631 million), even though their profits were only just over one-tenth as large, and though the part that they play in production is less than one-fifth of that played by private enterprise. It must be remembered here that total investment carried out in the country can never be more than the national income less current consumption plus borrowing from abroad; it follows therefore that the building materials, labour, machinery-producing capacity and so on that have been absorbed by the nationalized industries for their investment programmes have necessarily cut directly into the extent to which Britain can carry through other forms of industrial investment that might be of more use to the export drive or other essential objectives.

The case that is most frequently cited by those who believe that the nationalized corporations have pre-empted too large a share of Britain's limited supply of investible funds is the case of electricity supply. In recent years the fixed investment programme in this industry has tended to fluctuate around 70 to 80 per cent of its gross annual contribution to national income, while the relevant percentage for private manufacturing industry has been around 10 to 15 per cent. This nationalized industry has kept the price of electricity to consumers relatively very low, and it has made no attempt to charge more for consumption at peak hours than at hours when it has surplus capacity to spare; up to about 1951, indeed, the price of electricity in some areas was below pre-war levels. This low price encouraged an exorbitant demand, much of it of a luxury nature, which first pressed against the limits of available supply and then – at peak hours on one cold winter morning after another – spilled over the top of it. This caused repeated power cuts, with their attendant grave disorganization of industry. These power cuts were held, in turn, to justify the construction of still more new generating plants and a still larger fixed investment programme.

If the electricity industry had had to seek to raise capital on the Stock Exchange without the advantages of its Government guarantee, it is impossible to believe that it would have pre-empted as many investment resources as this; almost certainly, in post-war conditions, a private enterprise electricity industry would have taken the not very difficult technical steps necessary to choke off demand at the peak hours (which are the only hours at which the new capacity is likely to be fully used) by imposing a higher and differential tariff at those times. If the public had still gone on demanding a great deal of electricity at these higher prices, then the electricity companies would have made much bigger profits – and they would have had both the incentive and the funds to carry out their investment programmes. But if, as is more likely, the public had reacted to these higher tariffs by using less electricity at peak hours, then the companies would not have made much bigger profits and they would have carried out less ambitious investment programmes; and that would have left more resources free for house building or more urgent forms of industrial investment.

This seems to be a classic example of the maldistribution of resources that occurs when the capital market is, often without conscious forethought, prevented from working freely. There is no capital market problem for the nationalized industries, but there is a nationalized industries' problem for the capital market.

CHAPTER VI

WHO SAVES AND WHO BORROWS?

III. THE GOVERNMENT SECTOR

We can now turn to a preliminary examination of the rôle played by the Government on the capital market. We can deal first, and fairly briefly, with the local government authorities. We need not enter here into the ways in which the local authorities get their current income (rates, grants from the central Government, rents on local authority houses, etc.) or the forms taken by their current expenditure (education, local services, health, sanitation, etc.). Our concern is solely with the way in which they finance their capital expenditure – building new houses, schools and so on. Because their housebuilding programme has been so large, accounting for over 80 per cent of total housebuilding in Britain in the first eight post-war years, they have inevitably been heavy net borrowers all through the post-war period. From 1948 to 1952 the annual surpluses shown in the current budgets of local authorities (i.e. current income less current expenditure) were always in the range of £70 to £85 million; but their fixed investment programmes (two-thirds of them on housing construction) ranged between £250 and £450 million. Even after allowing for certain capital transfers to them, the lowest net borrowing of local authorities in any one of these five years was £263 million (in 1949) and their highest £433 million (in 1952).

The greater part of local authorities' net borrowing is direct borrowing from the central Government; in fact net loans to local authorities shown in the central Government's accounts for the financial year 1952–3 amounted to £395 million. Most of this borrowing is done at what are known as Public Works Loan Board rates of interest; at the moment (1953) the rates are 2⅝ per cent for loans up to five years, 3½ per cent for loans over five years but less than fifteen years, and 4 per cent for loans over fifteen years. These rates are adjusted from time to time so that they coincide fairly closely with rates ruling on the stock market for Government loans with a similar length of life. The central Government, in turn, can get the money either by borrowing in the market on its own account or out of its surplus current savings (if it has any).

Between the end of the war and the end of 1952 local authorities were only allowed to undertake long-term borrowing from the central Government. In 1953, however, they were again allowed to approach the stock markets direct if they wished. Several of the larger city and county corporations – Birmingham was the first – promptly did so. Since their standing was a little, but obviously only a little, lower than that of the central Government, they had to pay slightly more than P.W.L.B. rates on the bonds they floated. They were, however, able to choose the length of time for which they would borrow and arrange their investment habits a little more flexibly than if they had borrowed from the P.W.L.B. Local authorities also indulge in some short-term borrowing on mortgages (especially from the savings banks, but also from building societies and insurance companies), they can raise money by drawing bills that are dealt in on the discount market (using the mechanism described in Chapter XI), and at present (late 1953) they have some £75 million of advances outstanding from ordinary commercial banks.

The Central Government's Savings

The complicated operations of the central Government in the capital market will be a recurrent theme of discussion throughout this book; the object of the rest of this chapter is merely to set down sufficient statistics to round off the rough picture of borrowing and lending by different sectors in the capital market already sketched out, and to provide certain introductory remarks that are essential to understanding of the policy trends that we will discuss later.

First, then, the current 'savings' of the central Government consist, of course, of the money that it draws in from taxes on current incomes less the money that it spends on current goods, services, salaries of civil servants, pensions, social service payments and so on. The conventions of British Government accounting enter all tax receipts (including tax receipts that are really capital transfers) as ordinary or 'above-the-line' revenue, and all direct expenditure (including fixed capital expenditure on new post offices, defence establishments, etc.) as ordinary or 'above-the-line' expenditure. It is therefore inaccurate to assume, as some people tend to, that the 'ordinary' or 'above-the-line' budget surplus represents the Government's savings; in fact this above-the-line surplus, although a surprising amount of time and space is devoted in the Press to discussion of trends in it, is really a rather meaningless conception. But it is nevertheless usually possible to deduce from the full budget accounts what the Government's current saving has been in a full financial year; in any case, for the full calendar year the national income statisticians work out the sum for us. As we saw from our old friend, Table II, on page 26, the central Government had £337 million of current saving in 1952 and it also received £72 million net of capital transfers to give it a grand total of £409 million of investible funds.

The Government, like persons and companies, can use its investible funds either for the direct finance of new real investment or for net purchases of pieces of paper on the capital market. There are two main ways in which it can undertake direct real investment. The first way, of course, is for finance of its own capital expenditure. Table II, on page 26, showed that this capital expenditure amounted to £240 million in 1952; of this £92 million represented fixed investment in military establishments, £105 million represented other fixed investment (with the Post Office taking a surprisingly large slice) and £43 million represented stockpiling expenditure by Government trading bodies.

The other direct way in which the Government can use its investible funds is to make direct loans to certain favoured organizations. The major beneficiaries are, of course, the local authorities, but the central Government also made some loans in 1952 to the nationalized coal industry, to the Raw Cotton Commission (an official agency, now to be disbanded, that bought Britain's raw cotton from abroad), to a corporation that aided the depressed film industry, to colonial development corporations and to some others. All these direct loans are entered below-the-line in the budget accounts while most of the central Government's direct capital expenditure is entered above-the-line. It follows that the sum 'the central Government's current savings less its direct capital expenditure less these direct loans' comes up with an answer that is broadly equal to what is known as the 'overall' budget surplus or deficit (i.e. the surplus or deficit on both above-the-line and below-the-line items together).[1]

What does the Government do when it has an overall budget surplus or deficit? The short answer is that when it has a budget surplus of, say, £100 million then it can repay £100 million of its existing debt on the capital market; and that when it has an overall deficit of £100 million it has to borrow that amount on the capital market. But there is a complication. It arises from the country's balance of payments. To simplify this problem: when the country is running a balance of payments deficit this means that British importers are buying more foreign exchange from the Government than British exporters are selling to the Government – so that official holdings of foreign exchange run down, but official holdings of sterling run up. This means that the amount of sterling that the Government has available for repaying internal debt in any one year is broadly equal not to its overall budget surplus alone, but to this surplus plus what is known as the 'sterling counterpart of the balance of payments deficit'. In a year like 1952, when the overall budget accounts were in deficit but the balance of payments was in surplus, the Government had therefore two reasons why it had to borrow; in fact in the year to March 31st, 1953, its internal debt ran up from £23,723 million to £23,888 million.

The Central Government's Debt

Of what does this internal national debt consist? Table VII below shows how it was divided on March 31st, 1953, as between four groups: floating debt, non-marketable stock, marketable gilt-edged and what we have called 'other net sterling debt'. We can brush this '*other net sterling debt*' out of our discussion at once. It consists mainly of certain amounts of sterling that the British Government has agreed to hold ready for use by certain international organizations (like the International Monetary Fund) or overseas Governments. For example, when India gained its freedom from British rule in 1947, it handed over an annuity to Britain from which the British Government agreed to draw annual sums to pay the pensions of former members of the Indian Civil Service. The amount that has not yet been disbursed to these former Indian civil servants is held by the British Government but it is nominally still money belonging to India; it is therefore entered in the British Government's returns as a sterling debt to India, but it is not really a 'debt' in the sense of the term that is of interest to the capital market. The same applies to most of the £1,040 million of 'other net sterling debt' shown in Table VII.

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[1] There are certain complications here, arising chiefly from the fact that the income and expenditure of the national insurance fund are not shown in the budget accounts. But at the moment this is not a major discrepancy.

We can now turn, therefore, to the first of our four main categories – namely to *floating debt*. All of this is very short-term debt indeed. The major constituent at end March 1953, as will be seen from the table, consisted of £4,407 million of *Treasury bills*. These are securities of only 13 weeks maturity; it follows that each week at this time approximately £340 million of Treasury bills (i.e. one-thirteenth of £4,407 million) were having to be paid off. If the Government is in need of borrowing new money in any particular week, therefore, its first course is usually to issue a greater number of Treasury bills than are maturing in that week; while if it has surplus funds in any week

TABLE VII

INTERNAL NATIONAL DEBT AT END MARCH 1953

(£ million)

Floating Debt	
Treasury bills	4,407
Ways and means advances	307
	4,714
Non-Marketable Stock	
Terminable annuities	1,311
National savings certificates	1,748
Defence bonds	821
Tax reserve certificates	314
	4,194
Marketable Gilt-Edged	
Due to be repaid before 1961	5,088
Due to be repaid at some date after 1961	4,986
Undated stock	3,866
	13,940
Other net sterling debt	1,040
Total internal national debt	23,888

its new borrowing on Treasury bills falls short of the (in the spring of 1953 about £340 million) current maturities.

Treasury bills are of two sorts – 'tap' and 'tender'. Tap Treasury bills are merely an instrument on which the Treasury borrows any idle funds of the issue department of the Bank of England and other Government departments; they usually carry a lower rate of interest than tender bills and for our present purposes they can be regarded as a rather uninteresting accounting device within the Government itself. During the war and early post-war years, some Dominion and other friendly Governments that held exchange reserves in London were induced to hold part of these in tap bills instead of the higher yielding tender bills or other (still higher yielding) Government securities. But this practice was discontinued in 1952, so that all of the £1,570 million odd of tap Treasury bills outstanding at the end of March 1953 will have been held by Government departments. The main departments concerned are the issue department of the Bank of England, the Exchange Equalization Account and the funds controlled by the National Debt Commissioners. We will discuss these bodies and their functions in the next chapter.

We come now to the 'tender' Treasury bills, of which there will have been about £2,840 million outstanding at the end of March 1953. These are of much more direct interest to the capital market. Each Friday 'the Lords Commissioners of Her Majesty's Treasury' issue a formal announcement that tenders will be received at the Chief Cashier's Office at the Bank of England on the Friday following 'at 1 p.m. for Treasury Bills to be issued under the Treasury Bills Act, 1877'. The amount of the bills to be offered (in present circumstances usually around £250 million) is stated; and it is explained that the bills will be in denominations of £5,000, £10,000, £25,000, £50,000 or £100,000, and that they will be dated on any day of the succeeding week at the option of the tenderer. Officially, anybody can bid at the tenders – indeed the formal weekly announcement solemnly declares that 'members of the House of Commons are not precluded from tendering for these bills' – but everybody must submit his bid through 'a London banker, discount house or broker'; moreover, and here is the rub, 'each tender must be for an amount not less than £50,000'. As a result of this high minimum the only serious contenders at the tender are the

London discount houses, certain banks with offices in London (especially Dominions' banks, but – by agreement with the discount market – not the big London commercial banks), and the banking department of the Bank of England.

The twelve London discount houses co-ordinate their bids at the tender so as to make sure that they bid at the lowest possible figure, while still ensuring an adequate take-up of bills. Thus, at the tender nearest to the end of March 1953 – when Bank rate was 4 per cent – the discount houses bid at £99 7*s* 11*d* per £100 (i.e. at a rate of discount of 12*s* 1*d* per cent per three months, or £2 8*s* 4*d* per cent per annum) for the £230 million of bills on offer; probably they bid for about £200 or £210 million of bills, but as there were some £323 million of total applications for bills – some of them at higher prices than £99 7*s* 11*d* per £100 – the discount houses received an allotment equal to only 60 per cent of their bid. We shall be returning later in this book (and especially in Section II of it) to a discussion of the part played by the system of Treasury bills in the management of monetary policy and in the money market in general. All that we have tried to do here is to introduce the reader to the nature of this very important instrument of short-term Government finance. It should be added that since the Exchequer always gathers a large part of its tax revenue in the first three months of the calendar year (when, for reasons of administrative convenience, the bulk of profits tax, company income tax and surtax is collected), it tends to have an overall budget surplus in the period January-March but an overall budget deficit in the period April-December; in consequence new borrowing on Treasury bills usually falls short of the week's maturities between January and March, but often exceeds them between April and December.

The only other instruments of floating debt shown in Table VII are *Ways and Means Advances*. There were some £307 million of these outstanding at the end of March 1953 of which £303 million were held by public departments and £4 million by the Bank of England; the public departments concerned will have been the National Debt Commissioners, certain funds controlled by the Paymaster-General and a few other oddments. Ways and Means Advances are thus very much akin to tap Treasury bills; the latest annual Appropriation Act (at this writing) lays down that Ways and Means Advances shall 'be repaid, with interest not exceeding three pounds per cent per annum, out of the growing produce of the Consolidated Fund, at any period not later than the next succeeding quarter to that in which the money was borrowed'.

There is one other instrument of floating debt to which reference should be made here, although none was in issue at the end of March 1953. This is the *Treasury deposit receipt*, which was invented in July 1940 at a time when it was feared that an invasion of England might disrupt the money market and cause both legal and frictional difficulties about Government borrowing on Treasury bills. On each Friday between 1940 and 1951 the Treasury announced the amount that it was 'calling' from the clearing and Scottish banks (plus two overseas banks that agreed to play in the game); the amount called from each clearing bank was in strict proportion to its deposits. The 'calls' (at any rate under the system in operation from 1950 on) were for five-, six- or seven-month periods; interest at this time was ⅝ per cent per annum (against about ½ per cent for Treasury bills at that time). These 'T.D.R.s' were not transferable; but it was informally agreed that the Bank of England would buy them (at a discount equal to the current Bank rate) in the event of emergency, and it was formally laid down that a commercial bank could surrender Treasury deposit receipts to pay for its own or its customers' subscriptions to certain current Government issues always on offer (such as national savings certificates). At one time, in September 1945, there were no less than £2,225 million of T.D.R.s in issue, and they were the biggest single asset of the commercial banks. But in the six months to the end of February 1952 maturing T.D.R.s were allowed to run off without new calls; and on February 22nd, 1952, the Chancellor of the Exchequer announced the 'suspension' of the system, but declared that 'if and when the need arises, it may well be brought into operation again'. The significance for monetary policy of this rather rigid T.D.R. system, while lasted, will be discussed in Section II of this book.

Non-Marketable Debt and Gilt-Edged

We can pass fairly lightly over the next of our broad categories of Government debt – the £4,194 million of 'non-marketable stock shown in Table VII. Two of the items shown under this head, national savings certificates and defence bonds, were discussed in the last chapter. It was explained there that these securities can be bought at any time from the Government (often at a post office) at a fixed price and at a fixed rate of interest, but cannot be sold by one person to another.

The two other instruments of 'non-marketable' debt in this section are Terminable annuities and Tax reserve certificates. *Terminable annuities* are securities issued to the National Debt Commissioners for the accounts of the Post Office and Trustee Savings Banks; we will explain in the next chapter that when the Government does not want funds accruing to these banks to be invested in the gilt-edged market (where they would drive up prices), the Government may induce the Commissioners to invest instead in these Terminable annuities, which bore interest at 3 per cent during the war, 2½ per cent during the post-war cheap-money period, but 3½ per cent in a tranche issued in 1950.

Tax reserve certificates are instruments that were invented during World War II to meet the problem – already referred to – which arises from the fact that businesses (and some surtax payers) commonly run up tax obligations to the Treasury before the Treasury is ready to collect them. These people can buy Tax reserve certificates at £25 each. They receive (at the moment) 1¼ per cent in interest – free of income tax, surtax and profits tax – and they can tender them for payment of taxes not less than two, but not more than twenty-four, months after purchase. If they are not so tendered repayment is made to holders at face value but without interest. For those who have heavy tax obligations outstanding, and who have any part of their current income very heavily mulcted of surtax or profits tax, these are therefore a safe, convenient and economic form of investment. But for these people only.

Our final category in Table VII consists of the (in March 1953) £13,940 million of *gilt-edged securities* quoted on the London Stock Exchange. Of these, £5,088 million were due to be repaid at parity (that is at their nominal values) before 1961, £4,986 million were due to be repaid at some date after 1961, and the rest did not need to be repaid at all (although the Government had an option to repay them at some time in the future if it wished). All of these securities, of course, fluctuated in price on the stock markets; in fact although, as stated above, the whole stock of marketable gilt-edged had a nominal value of £13,940 million in March 1953 their total market value at that time was only £12,369 million. Naturally, however, those securities which were not due to be repaid until a long time hence (or which need not be repaid at all) fluctuated most in price, and therefore generally needed to carry the highest market rate of interest; while those which were due to be repaid in a very short time could not fluctuate in price very far from parity. We will make estimates in the following two chapters about who held these marketable gilt-edged securities of the British Government in March 1953. All that need be said here is that they are held by a wide variety of persons, institutions and companies both in this country and abroad; the market in them constitutes the largest single section of the London Stock Exchange.

Two additional points must be made before we leave this preliminary discussion of gilt-edged securities. The first is to amplify what is meant in Table VII by the phrases 'due to be repaid before 1961' and 'due to be repaid at some date after 1961'. The first category contains, for example, both a stock like '2¼ per Exchequer Stock, 1955', which has to be repaid in cash at 100 on February 15th, 1955; and a stock like '3 per cent War Loan 1955–59', which can be repaid at par on October 15th, 1955, if the Government wishes, but need not be repaid by the Government until October 15th, 1959, if market conditions are unpropitious.

Stocks such as these should be sharply differentiated from an 'undated stock' such as '3½ per cent War Loan, after 1952'. Since the earliest redemption date for this stock – December 1st, 1952 – has passed, the Government can repay this stock at par any time it likes; but it need not ever do so. At any one time there are usually a large number of stocks outstanding on the market whose earliest redemption date has passed; but if these stocks stand under par on the market, the Government naturally usually does not choose to pay off these stocks until it has to. At the moment of writing 'War Loan 3½ per cent, after 1952' stands at about 85 per cent of parity, so no redemptions have been made.

The final point to be made is that the £13,940 million of gilt-edged shown in Table VII consist only of the direct obligations of the British Government. Side by side with them in March 1953, however, were some £2,880 million of other gilt-edged called 'Government-guaranteed' issues. Most of these are our old friends the issues of the nationalized industries; the Government guarantees the interest payments and capital repayment in the same way as it guarantees payments on its own direct issues. We will see in the next chapter that there are many important investment institutions that can hold gilt-edged securities but not other stock exchange securities; it is largely for this reason that the nationalized industries have been able to 'hog' such a large share of the scarce supply of investible funds coming on to the capital market in recent years – but this is the horse that we have already flogged in the last chapter.

CHAPTER VII

THE INSTITUTIONAL INVESTORS

It is unwise to be dogmatic about the trend of savings and borrowing as between different sectors from the information analysed in the last four chapters. Just after the war it looked as if Britain was entering a period when persons, companies, the nationalized industries and the local government authorities were all going to save less than they needed to finance their investment commitments; unless that investment was to be financed by persistent borrowing from abroad (that is, by persistent balance of payments deficits), therefore, it seemed that the central Government might have to continue to force savings out of the community by running large budget surpluses and imposing the heaviest possible taxation (which in turn would make the adequate provision of risk capital by personal investors even more unlikely). The Government would then have to use these surpluses either to finance direct investment on its own account, or to repay debt to the private capital market – and hope that the money derived from these repayments would be used for private real investment.

The apparent shortfall of savings in the company sector in these years was, however, partly due to persistently rising raw material prices. As was observed in the footnote to page 46, if companies were to replace stocks at these higher prices they had to put up the selling price of goods manufactured from raw materials that had been bought at lower price levels; but as the 'windfall profits' arising from these increases in selling prices were taxed in just the same way as other profits, some 50 to 70 per cent of the funds thus deliberately created for stock replacement were sucked into the Inland Revenue's maw – and then had to be borrowed back again from the Government through devious routes.

The resort to a dearer money policy at the end of 1951, and the check to the rise in raw material prices that accompanied it, brought this phase to a possibly temporary end. In 1952 and 1953 companies saved more than was required for their own investment needs, while the Government relapsed into heavy overall budget deficit. It is impossible to say whether this changed flow of the tide will continue, but at any rate the thesis that the central Government will always be the only sector that is a purveyor of net investible funds in post-war Britain now seems to be exploded. There must also be greater hopes than there were just after the war that in most future years persons will be able to save much more than the one to three per cent of personal incomes which was all that they managed to save in 1946–51.

What does seem certain, however, is that we will not return for a long time to a state of affairs where a large proportion of these personal savings goes directly into risk-bearing securities. The social philosophy adopted by the two great political parties in Britain today ensures that there will not be as many very rich people in the country as there were before the war. And, naturally, it is only the comparatively rich who have sufficient savings to feel able to put a substantial proportion of their fortunes at risk. The rest of us look around for the safest possible way in which to hold our savings.

It is here that the great institutional investors come into the picture. These institutions do not give rise to any great savings on their own account – in the sense of earning large incomes and making small spendings. They collect other people's savings instead. On the liabilities side of their balance sheets are large sums of savings that have been lent to them by other people, who know that they are very safe institutions to leave money with; and on the assets side are either the loans they make to people who want to undertake real investment or else securities that they have bought in the stock markets and elsewhere.

Of course, not all of the institutions discussed in this chapter are quite of this type. The banks, for example, can create some of the money they lend out of thin air; this, however, is a complication that we can leave aside until the second section of this book – it is quite proper to do so, because until about forty years ago very few people realized that the complication existed, and their lack of recognition did not prevent them from efficient handling of the day-to-day operations in the London capital market (or indeed from creating that market in the first place). Again, the foreign governments that invest their exchange reserves in London, usually through the agency of their central banks, obviously do not invest savings collected from the British people. But since they play such a large part in the London capital market, it seems wisest to consider them in this chapter nevertheless.

The object of this chapter, then, is simply to effect a formal introduction between the reader and these institutional giants. In a very bald summary, the chapter will set down the names and nature of these institutions, where they borrow their money from and how they lend or invest it. By the end of the chapter we will have traced the ownership of practically all the Government's floating debt. We will also have traced about £10,000 million of the £14,800 million odd of variable price Government securities (or 'gilt-edged') that were outstanding on the Stock Exchange at the end of March 1953 but less than £3,000 million of the £12,350 million odd of industrial and other risk securities that were quoted on the Stock Exchange. Since we will also have shown – or tried to show – what a very large part of current savings in the last few years has found its way into the hands of these institutions, the chapter will also give some idea of the present trend of savings towards institutions that specialize in safer (especially Government) securities rather than risk securities. If nationalization in 1945–51 had not transformed so large a segment of industrial securities into Government-guaranteed securities, the risk capital problem would have become much more obvious than it has done. But then without the nationalizations, there would probably also have been a better distribution of the risk funds that are available.

The institutions that we will discuss in this chapter fall under four main heads:

(*a*) Government Departments;
(*b*) the Banking System;
(*c*) Overseas Countries' Sterling Balances;
(*d*) Other Institutions – especially the insurance companies, building societies, investment trusts, and pension funds.

The Government Departments

The first group of institutional investors that we must examine are what are popularly known in the markets as the 'Government Departments' – that is to say, the official institutional investors whose investment policy can be directly under the

Government's control. These can be split under four heads – the National Debt Commissioners, the Bank of England, the Exchange Equalization Account and what might be called 'other driblets'. Together these seem to have held between £6,500 and £7,000 million of Government or Government-guaranteed securities by March 1953 – probably including some £3,000 million of the £16,800 million nominal (but just under £14,800 million in market value) of marketable gilt-edged then in issue, about £2,000 million of the £4,714 million of floating debt then in issue, and certainly including all the £1,311 million of Terminable annuities in issue. These four groups do not, however, hold any other form of British investment than Government or Government-guaranteed securities (apart from a few loans to local authorities from funds under the National Debt Commissioners' control).

The biggest investor of these four groups, the *National Debt Commissioners*, was originally created over one hundred and fifty years ago by the younger Pitt, in order to manage his sinking fund. Since then they have become a convenient body to manage any investment fund that has come under the Government's wing – and especially the money deposited by the public in the Post Office and Trustee Savings Banks, and the great social insurance funds.

The total portfolio of the National Debt Commissioners was in excess of £4,500 million by mid-1953. Of these about £3,000 million was held for what the Commission's Comptroller General likes to call the 'guaranteed funds'; by far the most important of these are the funds held against the public's deposits at the Post Office and Trustee Savings Banks, but a few odds and ends like the Supreme Court Deposit Account and the County Courts Fund come in here as well. The other £1,500 million odd was held for what the Comptroller General calls the 'trust funds'; the investments held as backing for the National Insurance Fund are by far the biggest item here, but there are a string of smaller fry like the Industrial Injuries Fund and the Hospitals Endowment Fund.

Up to 1951 the national insurance fund and the industrial injuries fund were growing at a rate of around £160 million a year, but in his Budget Speech in 1951, Mr Gaitskell announced that he was cutting off part of the Exchequer contribution to this insurance fund, so that their assets have now ceased to grow;

in fact, the actuarial expectation is that – unless national insurance contributions are raised – the funds will swing over into deficit in the mid-1950s because of an increase in the number of old-age pensioners. Changes in the savings bank accounts from year to year depend wholly, of course, on the amount of saving that the public is undertaking through these banks; in recent years net withdrawals from these banks have tended to exceed the banks' investment income, so that these funds have also been tending to decline. The other funds under the National Debt Commissioners' control are too small for changes in them to matter much. In contrast to the position before the Exchequer contribution to the national insurance fund was cut down in the 1951 budget, therefore, the National Debt Commissioners now (1953–4) probably have no net new funds to invest on the market year by year. But the huge size of their £4,500 million portfolio, of course, gives them plenty of room for switching operations, and these are of very great importance for the market.

Some idea of the way in which this switching is operated was given by the Comptroller General of the National Debt Office in his evidence before the Parliamentary Public Accounts Committee in June 1952. The Comptroller declared that in his management of the 'trust' funds – that is, principally, of the national insurance funds – he considered himself obliged to follow a settled investment policy 'which in no case would put anything higher than the interests of (his) beneficiaries'; like the manager of any other insurance fund he tried to arrange his portfolio so that the maturity dates of his securities accorded with the likely future pattern of demands on the fund for benefits (e.g. if a 'hump' of new old-age pensioners is expected in the early 1970s, he will invest in many gilt-edged stocks that are due to be repaid then).

In his management of the savings bank or 'guaranteed' funds, however, the Comptroller General agreed that one of his main duties was to keep in step with Government monetary policy; when the Treasury wanted funds lent directly to it instead of seeing those funds used for buying (and thus driving up the price of) gilt-edged securities on the stock markets, the Comptroller lent money to the Treasury against new floating debt or new Terminable annuities – and he also participated in a cooperative fashion in any Government new issues (including new issues by the nationalized industries). Since the Comptroller General also declared that he managed to keep in the 'savings banks funds a reservoir of securities suitable not only for them but also for the trust funds and sell them to the national insurance fund currently', it seems clear that his whole *masse de manouvre* is in effect almost entirely at the Government's disposal for the operation of its monetary policy. By sending the Comptroller General into the market to buy gilt-edged at the expense of his holdings of floating debt, or else to sell gilt-edged in order to add to his holdings of floating debt, the Government can do a great deal to drive gilt-edged prices up or down.

We shall see later, in Section II of this book, that this is a very important point for the management of the economy in general. It should be added that the Comptroller General is a civil servant, and has weekly meetings with the Bank of England and periodic meetings with the Treasury – at which he no doubt gets advice on the current trend of the Government's monetary policy and confidential information about any new Government issues impending.

The second major institutional investor under the Government's wing is the nationalized *Bank of England.* One of the Bank's weekly balance sheets, that for May 27th, 1953, is analysed at some length in Section II of this book. The similar balance sheet for April 1st, 1953, showed that on that date the Bank held (in its Issue and Banking Departments combined) just under £1,900 million of Government securities and some £70 million of other assets. The liabilities held against these assets consisted of just under £1,550 million of notes and just over £400 million of deposits belonging to the Exchequer, commercial banks and others. In recent years the Bank of England has tended to have an increment of around £50 to £100 million of net new investible funds a year. This is because the Bank's liabilities, and especially the note issue, have tended to rise during the years of inflation; when people add to their holdings of bank notes, of course, they are adding to their savings in a particularly liquid form, but by so doing they add to the liabilities of the Bank of England and enable it to hold more Government securities on the assets side of its balance sheet as counter to these new liabilities. No information is published about the division of the Bank of England's portfolio of Government securities as between floating debt and marketable gilt-edged, but switches within this portfolio are probably an even more important weapon of Government monetary policy than similar switches within the portfolio of the National Debt Commissioners.

Even less is known about the portfolio of the *Exchange Equalization Account* than about that of the Bank of England. The E.E.A. is the body which was set up in the 1930s to hold Britain's gold, dollar and other foreign exchange reserves. It buys these dollars from exporters and sells them to importers; when it is buying more than it is selling – in other words when the country is in dollar surplus – the Government has to raise the sterling to make these net purchases. It does so by borrowing operations on Treasury bills. These borrowing operations usually take place in dollops of £200 or £300 million, and between these borrowing operations the E.E.A. has, of course, some idle sterling to hand. It re-invests this sterling mainly in the new Treasury bills that the Government has just created; in fact, when one of these 'lump' borrowing operations takes place, the new Treasury bills are issued directly into E.E.A.'s account.

The E.E.A.'s balance sheet at any one moment, therefore, consists of a certain sum borrowed on Treasury bills on the liabilities side of its account, and a gold and foreign exchange holding plus a small holding of (probably) Treasury bills on the assets side. Although the total of its past borrowing operations are known, and so is its holding of gold and dollars, it is impossible to work out its sterling holding at any one time; this is because some of the gold and dollars it holds were bought at rates other than the present rate of $2.80 to the £, and because E.E.A. also has a portfolio of foreign securities about which no information is published.[1] Probably, however, that sterling holding is never allowed to mount much above £300 million (and usually, it may be lower than that). If it does rise markedly – because Britain is losing gold, and the E.E.A. is having to sell more gold to importers than it can buy from exporters – the Government cancels some of its sterling holding and also cancels some of the Treasury bills on the liabilities side of E.E.A.'s balance sheet.

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[1] Some of the dollar securities – including many ordinary shares in American companies – that were taken over from British residents by the Government during the war, have remained in the hands of the E.E.A., which now in effect operates a sort of investment trust in North American securities in addition to its other duties. But no figures are published about the size of these holdings; they are not included in the official total of the gold and dollar reserve.

The remaining investment holdings under the Government's wing we have called 'other driblets'; there are certain minor holdings, such as those of the Custodian of Enemy Property or the Crown Lands Commissioners which fall into this category. Up to 1951 periodical parliamentary questions elicited statements from the Chancellor about the combined holdings of the National Debt Commissioners and of those whom we have called these 'other driblets', and now these figures are published annually in the national debt return which comes out in the autumn. At the end of March 1953 the Government declared that departmental holdings (on this definition) amounted to £321 million of floating debt and £3,236 million of other national debt (in nominal values).

TABLE VIII

ESTIMATED HOLDINGS OF GOVERNMENT OR GOVERNMENT-GUARANTEED SECURITIES BY GOVERNMENT DEPARTMENTS AT END MARCH 1953

(£ million)

National Debt Commissioners		4,500
Bank of England		1,900
Exchange Equalization Account and 'other driblets'	say,	200
Total		6,600
Of which:		
Floating debt	say,	2,000
Other non-marketable	say,	1,600
Gilt-edged	say,	3,000

Since the total holdings of the National Debt Commissioners at this time were believed to have been around £4,500 million in market values, this seems an odd statistic; at first sight it suggests that the holdings of 'other driblets' should have been about minus £1,000 million. But the explanation is that the Government's figure does not include the National Debt Commissioners' large holdings of Government-guaranteed stocks – and especially their very substantial participation in the massive new issues by the nationalized industries since the war. Nevertheless, it is a fair conclusion from it that the holdings of 'other driblets' were not large.

Table VIII summarizes the very rough estimates that we have been able to cull so far; it should be emphasized that the guess at the holdings of the E.E.A. and 'other driblets' is a guess only. The guess that about £2,000 million of the total estimated portfolio of about £6,600 million will have been held in floating debt arises from the fact that all the tap Treasury bills and Ways and Means Advances in issue (around £1,900 million at this time) must have been held in these portfolios and that the Banking Department of the Bank of England probably also held some (but not too many) tender Treasury bills in its £342 million portfolio of Government securities. The item 'other non-marketable debt' includes the Terminable annuities, traceable loans to local authorities from funds controlled by the National Debt Commissioners and a few other oddities (such as certain interest-free notes and paper debts to the Government in the Bank of England's portfolio). It is a very uncertain statistic, and this means that the estimate of £3,000 million for departmental holdings of gilt-edged is very uncertain, too.

It should be emphasized at this point that we have not counted such entities as the Colonial Currency Boards, the Public Trustee, the Ecclesiastical Commissioners and the Charity Commissioners as Government departments in this section. The funds of these independent bodies cannot be used in the market for furtherance of the Government's monetary policy in the same way as those of the departments proper – although it is perhaps significant that some unkind people in the market call the Colonial Currency Boards (at any rate) the departments' 'cousins'. But even without the cousins, the official *masse de manouvre* is clearly very large.

The Banking System

We must now turn to examine the holdings of the banking system. The main *dramatis personae* to be considered in this section will be the eleven clearing banks, the Scottish and Irish banks, the twelve discount houses and the fifteen or so large merchant banks (or acceptance houses as they are sometimes called). It will also be convenient, however, to consider in this section the forms of investment in which foreign countries hold their sterling balances.

The eleven London *clearing banks* comprise seven very big banks (the Midland, Barclays, Lloyds, National Provincial, Westminster, Martins and District) and four smaller ones; they take care of the money of about one out of every six British workers and earners, and in March 1953 (a convenient date to take in order to fit in with the estimates in Table VIII), their net deposits amounted to just under £5,850 million. Against these, their main assets were just over £950 million of Treasury bills, just over £2,120 million of marketable gilt-edged securities (almost all of them short-dated, mostly with maturity dates of under 10 years) and nearly £1,800 million of advances to industry and commerce. We will be returning on several occasions in this book to further discussion of these assets, and all that needs to be said here is that the clearing banks' advances are all intended to be for short-term purposes and repayable at very short notice. The clearing banks' other assets in March 1953 consisted of just under £70 million of commercial bills, just under £500 million of cash and deposits at the Bank of England and just under £475 million of very short-term loans to the discount market (which enabled the discount market to hold the portfolio that will be discussed below). The clearing banks' net deposits – and thus their total assets – rose by between £200 and £250 million in both 1947 and 1948, by between £100 and £150 million in 1949 and 1952, but they fell by £65 million in 1951. We will discuss the factors that induce them to switch from one form of assets to another in Section II of this book.

Side by side with the clearing banks are six important *Scottish banks* and ten important *Irish banks* that perform broadly the same functions. The Scottish banks held some £760 million of deposits at their several accounting dates nearest to March 1953; their assets included £360 million of marketable gilt-edged securities (probably with slightly, though only slightly, longer average maturity dates than the clearing banks), £30 million of bills (mostly Treasury bills) and £210 million of advances. The Irish banks (excluding the National Bank, which is also a London clearing bank) held some £300 million of deposits at the end of 1952; most of their deposits, and of their advances, were of course in Ireland, but their assets included over £100 million of marketable British Government securities. Many of these, however, will appear later in this chapter, among the sterling balances, and they are not listed separately in Table IX.

The twelve London *discount houses* – whose activities we will be discussing at some length in Section II of this book – comprise three fairly big companies (the Union, the National and Alexanders) and nine smaller ones. Their function is to borrow money on very short term from the clearing and other banks (most of it liable to recall at a moment's notice), and to invest it in very short-term securities or bills. Although three of the twelve discount houses are registered as private companies and therefore do not publish balance sheets, it can be estimated that at the beginning of 1953 the discount market's total portfolio consisted of about £300 million of marketable gilt-edged securities (but all maturing within about four years), about £750 million of Treasury bills, and perhaps rather under £50 million of commercial bills. This total portfolio of around £1,100 million was supported by only about £30 million of the discount houses' own capital resources, and by over £1,050 million of short loans to them from the commercial banks. For the purposes of the present analysis, therefore, the discount market can be regarded as a sort of specialist sub-contractor for the commercial banking system, with great expertize in the investment of very short-term funds in very short-term Government (and a modicum of commercial) securities. This division of functions is very useful for the commercial banks and we shall see later that it is also very useful for the Bank of England; from the point of view of other institutional or personal investors who want to hold short-term Government securities, of course, it is also a matter of convenience that there should be these expert institutions with a plentiful supply of such stock ready to hand.

The next group to be considered must be the big *merchant banks*, or *acceptance houses* as they are sometimes called. Nearly all of these are private concerns and therefore do not publish balance sheets; these private concerns include such great houses as Rothschilds, Schroeders, Kleinworts, Lazard Brothers and so on – and very often the actual managership of the business is still carried on by a member or members of the founding family. Merchant banks carry out a confusing array of operations. They started as a source of short-term finance for international trade by lending their names rather than their money. They 'accepted' the bills drawn by foreign traders – which means that they guaranteed that these bills would be paid, and thus made the drafts concerned documents that could readily be sold on the market; we shall see later that between one-half and three-quarters of the commercial bills dealt in on the London market still originate with 'acceptance' by a merchant bank in this way. From this function as a source of short-term finance for international trade, it was a logical step for the merchant banks to turn to acting also as agents for overseas governments and commercial concerns that wished to raise long-term finance on the London Stock Exchange; and from this it was again another logical step for the merchant banks to become interested in the arrangement of domestic issues on the Stock Exchange, so that all the big merchant banks are now issuing houses as well. They also deal in foreign exchange, and some aid important clients in their investment policies, deal in premium sales of gold and carry out a wide range of other miscellaneous financial business.

TABLE IX

ESTIMATED HOLDINGS OF BANKING SYSTEM AND OVERSEAS OWNERS OF STERLING BALANCES AT END MARCH 1953

(£ million)

	Treasury bills	*British gilt-edged*	*Advances to British industry, commercial bills, etc.*
Eleven clearing banks .	950	2,120	1,870
Six Scottish banks .	30	360	210
Twelve discount houses .	750	300	50
Merchant banks .	say, 60	say, 30	say, 100
In the sterling balances .	say, 850	say, 2,000	—
Total . .	say, 2,650	say, 4,800	—

The merchant banks also take in deposits; sometimes these have arisen through the sinking funds for loans that they have floated on the market in their capacity as issuing houses, sometimes they have come from people who use their services in other ways, sometimes they come from ordinary people or commercial concerns (although their deposits also include a large proportion of foreign money). In general, these deposits will be in larger 'lumps' than those held by the clearing banks. There are fifteen merchant banks that are members of the Accepting Houses Committee, and they have a paid-up capital of over £30 million: rough analysis of the few balance sheets that are available suggests that these houses may hold around £300 or

£400 million between them in deposits, while their acceptances on commercial bills may have been around £150 million[1] at one time in 1951. If the experience of Hambros, the biggest merchant bank to publish accounts, is typical, about half of the assets held against deposits may be in cash and call money lent to the discount market, another quarter in discounts (including Treasury bills) and investments, and another quarter in trade investments, advances and loans. In recent years several merchant banks have participated in ambitious development schemes in Canada and elsewhere in the Commonwealth, and it is unlikely that their total holdings of British Government securities or British stock exchange securities are very large. The estimates given in Table IX for the merchant banks' stake in this field are, however, very tentative.

Two other types of banks that deserve mention are *British-owned banks that trade overseas* (and that usually have their head offices in the City of London) and *overseas banks* that have branches in London. The British banks trading abroad include such giants as Barclays (Dominion, Colonial and Overseas), the Chartered Bank of India, Australia and China, the Hong Kong and Shanghai Banking Corporation and the Bank of London and South America. Although these banks hold large portfolios of British Government securities, these holdings – as far as can be seen – are usually included in the sterling balances of the overseas countries, which will be discussed below. To avoid double counting no separate assessment of them need be made here. The same applies, of course, to the London funds of overseas banks with offices here. In all, there are some 15,000 banks from all over the world that have agents or correspondents or other forms of representation in London. Most of them, however, merely have London banks as correspondents – which means to say that they maintain an account with these London banks and route business through them; others have agents, who are sometimes merely one man with a secretary or a clerk, to look after their interests. The numbers that have official branches in London are comparatively small (at this writing, just under fifty), but there are American, French, other continental, and, of course, Dominion banks that do.

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[1] There is some sort – admittedly it is a shaky sort – of double check on this Both Hambros and Barings reported their acceptances in 1952–3 at just over one-third of deposits Total stamped bills outstanding in Britain in 1951–2 were about £575 million, and about 40 per cent of this (or about £230 million) is likely to have been first-class paper that passed through the London discount market Figures published by one discount house (Jessel, Toynbee & Co.), have shown that between 55 and 70 per cent of the paper passing through their hands since the war has been accepted by merchant banks, and £150 million is 66 per cent of £230 million.

We come now to the *overseas sterling balances*, which amounted to £3,434 million (excluding Britain's debt to the non-territorial organizations, which is invested in interest-free notes) at the end of 1952, and £3,609 million at the end of June 1953; perhaps, therefore, we can put the total for March 1953 at £3,500 million. The official definition of the funds included under this heading is:

> Sterling balances comprise the net liabilities in sterling of banks (including accepting houses and discount houses) in the United Kingdom to their overseas offices and to other account holders abroad, including any British Government securities held for account of banks and funds held as cover for overseas currencies; funds held by the Currency Boards and with the Crown Agents for the Colonies; overseas loans to H.M. Government expressed in sterling or sterling area currencies, including the capital value of payments due to India and Pakistan under the Pensions Annuities Schemes of 1948 (£145 million in mid-1953); and, so far as known, U.K. sterling securities held by official bodies but not those held by private individuals or firms. Holdings of Dominion and Colonial sterling securities are excluded.

In order to assess how much of all this was held directly by these overseas holders in the form of British Government securities (including both Treasury bills and marketable gilt-edged) we must therefore make certain deductions and amendments. First, we must strike out the portion that represents the Indian and Pakistan annuity (for pensions of former Indian civil servants) and certain other balances that are readily traceable in the national debt return as loans of this same special kind; this leads to a deduction of about £255 million. Secondly, we must strike out the proportion that is held as call loans to the discount market; it is known that the Commonwealth Bank of Australia and the National Bank of Egypt were especially heavy lenders here, and perhaps £200 million might be a reasonable deduction for the conditions of early 1953. Then we have to make a guess – it can only be a guess – at how much is held in the form of deposits at the clearing banks or the merchant banks. It would not be surprising if, after all these deductions were made, it proved that about £2,850 million of the £3,500 million of sterling balances were held in Treasury bills or British Government securities in early 1953. This is, accordingly, the figure set down in Table IX. We have also made a bold guess in that table, working back from the aggregate of Treasury bills, about how much of this may have been held in marketable gilt-edged rather than in Treasury bills.

It is worth noting here that the proportion held in gilt-edged seems to have been rising in recent years. One reason for this is that the Colonial Currency Boards and Marketing Boards hold a relatively large proportion of their balances in marketable gilt-edged; and it is the colonial countries whose balances have been increasing most steadily in the last few years.

Other Institutional Investors

The other five main types of institutional investors of importance to the Stock Exchange are the insurance companies, the building societies, the investment trusts, the non-insurance pension funds and the friendly societies. The *insurance companies* are by far the largest of these. As Table X shows, the total assets of all insurance companies that were established in Britain and that reported to the Board of Trade were £3,590 million at the end of 1952. To these, however, should be added over £200 million of the funds of friendly societies that carry on certain types of insurance (especially 'industrial' or 'home service' life insurance, which simply means life insurance for which premiums are collected in small sums by a door-to-door collector); and perhaps another £200 million of assets held in Britain by insurance companies that are not 'established in Britain' under Board of Trade definitions. This makes a grand total of about £4,000 million of insurance funds at end 1952. Over £2,500 million of these were probably held in the form of stock exchange securities, and the total funds of these offices and societies are currently increasing at a rate of between £250 and £300 million a year. In order to avoid exaggeration of the importance of these accretions to the British capital market, however, a sharp distinction should be drawn between the life and annuity business of these offices and their fire, accident, and marine business.

It is the life and annuity funds of these offices that are of major importance to the British capital market. These funds amounted to about £2,900 million at the end of 1952. Of these about £1,550 million were 'ordinary' life funds, about £950 million were 'home service' life funds, and about £400 million were the funds of pension 'schemes' that are organized for private businesses by the life offices. The current rate of growth of all life funds is about £170 million a year – about £80 million a year on ordinary life funds, about £40 million a year on home service life funds, and about £50 million a year on the very rapidly increasing pensions 'scheme' business. Much of the counterpart of these new accretions to life funds is invested in British stock exchange securities. An analysis by the *Economist* of the life and annuity funds of forty-two leading offices at the end of 1952 showed that over 34 per cent of their assets were

TABLE X

ASSETS OF ASSURANCE COMPANIES ESTABLISHED IN BRITAIN, 1949–52

(£ million)

	End 1949	*End* 1952	*Average annual growth* 1949–52
British Government or Government guaranteed securities	1,131	1,139	+3
Dominion and Colonial Government or municipal securities	113	150	+12
Foreign Government or municipal securities	143	196	+18
Ordinary shares	306	412	+35
Preference shares	223	266	+14
Debentures	249	373	+41
Loans on public rates and British municipal securities	105	100	−2
Mortgages	188	311	+41
Other assets	445	643	+66
Total	2,904	3,590	+229
Add Insurance Assets of Friendly Societies and certain other offices (see text)	300	400	+30
Approximate Total	3,200	4,000	+260

held in gilt-edged; over 12 per cent in ordinary shares; over 12 per cent in debentures; 7 per cent in preference shares; over 6 per cent in foreign government or municipal securities; and under 28 per cent in mortgages, policy loans, property, cash and so forth.

It will be seen from Table X that not many of the net new accretions to life funds since the war have been invested in gilt-edged (portfolios of which ran up heavily in the war). Important new outlets for funds have been ordinary shares, debentures and mortgages (apart from the residual 'other assets'). It often happens, however, that the big insurance offices find it difficult to invest, on the scale in which they are accustomed to deal, in existing ordinary shares – without the very fact of their purchases, in a narrow market, driving up prices against them. They are therefore resolute supporters of sound new issues. These relatively heavy purchases of risk assets by the life offices—and the growth of pension business which has made these purchases possible – have been a major factor in disguising the acuteness of the risk capital crisis in post-war Britain; perhaps they have been second only in importance to the transfer of securities from the 'risk assets' to the 'gilt-edged' class as a result of the big nationalizations of 1945–51 as a disguising factor. But, presumably like those nationalizations, they have been something of a temporary factor; the life offices have been directing most of their new purchases into risk securities rather than into gilt-edged after their heavy purchases of gilts in the war; since the offices must always put the interests of their policy holders first, it must be expected that they will one day turn back again to buying rather more gilt-edged and rather less equities with their new funds. (As the life funds still held 40 per cent of their assets in gilt-edged and foreign government and municipal securities by end 1952, compared with 29 per cent before the war, however, it is to be hoped that they feel they still have some way to go.)

The investment pattern of the insurance companies' non-life funds is very different from that of the life funds. Something like 70 per cent of the non-life (i.e. fire, accident, marine, etc.) business of British insurance companies is transacted overseas or in London on foreign account. Because of unstable exchange rates and the statutory requirements of many foreign countries, a very substantial part of the assets against this business have also to be held abroad – often in liquid balances or in foreign government (especially United States Government) securities. By the end of 1952 the *Economist* estimated that some 57 per cent of the non-life assets of sixteen leading offices were held either in cash or in foreign government, provincial or municipal securities; another 14 per cent was held in British Government securities, only 8 per cent each in ordinary shares and debentures, and only 5 per cent in preference shares. An increase in the non-life funds of British insurance companies is therefore not of such direct consequence to the London Stock Exchange as an increase in their life funds; although its importance should not, of course, be underrated.

The *building societies* are another group of institutions whose assets were expanding, at around or over £100 million a year, in the late 1940s and early 1950s; we saw in Chapter IV why people have found them a very safe and profitable sort of institution with which to leave their money. At the end of 1952, the total assets of the eight hundred or so building societies in Britain amounted to just under £1,500 million. Over £1,250 million of these funds were out on mortgage loans, and more than 1,500,000 people had borrowed from the societies in order to buy their homes. In addition, however, the societies held some £160 million of gilt-edged and nearly £50 million of cash at the banks or in hand. The heavy demand for housing loans just after the war, mostly from people buying second-hand houses, exceeded even the healthy inflow of new savings into the societies; the movement was therefore a net seller of gilt-edged securities in the first seven post-war years – to the tune of over £50 million. The societies do not invest in risk securities on the Stock Exchange.

The next group of institutional investors to be considered are the *investment trusts*. These trusts raise their capital by floating risk securities on the Stock Exchange and they use that capital to invest in other risk securities in their turn. In effect they say to the personal investor: 'Left on your own you are very likely to pick all the wrong industries at all the wrong times for investment of your money. Entrust your money to us and your investment will be undertaken by a body of experts, and you can share in the fruits of our wise decisions; you can take up ordinary shares, preference shares or debentures as you like.' This basic principle is obviously sensible, although it has not worked out in practice as well as it might have done. This has been due to three main reasons: first, not all the trusts have been as expert as they should have been; secondly, trusts always find it easiest to raise new capital at the top of a boom (and thus have an unfortunate habit of putting that new money into the Stock Exchange just before a slump comes along); and, thirdly, trusts do not find it as easy as some expert private investors to take their money out of the Stock Exchange and 'go liquid' at a time when prices seem due for a fall (because they have to keep some earning assets in order to find the wherewithal for debenture interest and share dividends).

In early 1953 there were some 234 investment trusts whose shares were quoted on the London Stock Exchange and the market value of their portfolios was around £580 million. In addition, there were a number of trusts whose shares were sold on provincial stock exchanges instead of on the London Stock Exchange (Scotland is one of the traditional homes of the movement) and there were the so-called 'unit trusts' who seem to have held about £100 million of securities at this time. Unit trusts are bodies that say to investors 'Your money will be invested only in the following high-grade equities' (either in stated proportions if the trust is a 'fixed' one or variable proportions if it is a 'flexible' one). The equities concerned are held by trustees (often a bank or insurance company), not by the managers of the trust; and if a trust were set up with, say, a thousand units anybody with one unit would have a one per mille stake in the fund.

Investment trusts have traditionally taken an especial interest in overseas securities. Of the portfolio of £580 million quoted above for the 234 investment trusts whose own shares were quoted on the London Stock Exchange, about 15 per cent was invested in the Commonwealth, 25 per cent in North America and 9 per cent in other overseas countries. Not all of these overseas securities, of course, were quoted on the London Stock Exchange; this fact, together with the impossibility of assessing the holdings of investment trusts whose own shares are not quoted in London, must be borne in mind when reading the very rough estimates set down in Table XI.

Unfortunately, the investment trusts were not able in the early post-war years to fulfil their much needed function as a channel by which risk-seeking savings might reach the Stock

Exchange. By an almost incredibly silly decision of the first Labour Government, the trusts were banned for a time from raising new funds on the market on the totally illogical grounds that to raise capital for mere 'financial operations' would draw off resources needed for reconstruction. During this period, therefore, the trusts could only increase their portfolios by ploughing back profits. Fortunately, in July 1953, the Chancellor of the Exchequer wrote a letter to the Capital Issues Committee (which is the body that vets new issues and of which we will have more to say later) declaring:

> 'the time has come when some departure from the rigid application of this policy is desirable, having in mind the part played by the investment trusts in the supply of risk-bearing capital for industry and the need to encourage savings at the present time.'

He therefore told the Capital Issues Committee that in appropriate cases it could authorize issues by investment and unit trusts. In view of the disappointing experience of some trusts in the pre-war years, it remains to be seen how much relief this long-delayed step back to sanity will bring to the growing risk capital problem.

Our final group consists of the *pension funds* operated by business firms otherwise than through pension schemes arranged with insurance companies (and included in the analysis of life funds above). It has been suggested by some commentators that these pension funds now have accumulated assets of nearly £1,000 million and are growing at around £100 million a year.[1] Some business pension funds are re-invested in the company concerned, in real property or in non-marketable securities, but there can be no doubt that the stock markets have got much recent grist from them. In addition to these private pension schemes, local government staff superannuation funds contain over £250 million of assets and are growing by some £25 million a year (some of this money is re-borrowed by the local authorities themselves); there are also several semi-public superannuation funds that are reported to the Registrar of Friendly Societies, as well as pension schemes that are being started in the nationalized industries. Even after allowing for holdings of real property, mortgage loans, and similar investments, about £1,250 million may be a fair guess for the total marketable securities held by all private and public pension schemes (other than those handled through the insurance offices, or the social insurance schemes handled by the National Debt Commissioners); and this holding of securities is probably growing by over £100 million a year. Such evidence as is available suggests that pension funds are conservatively invested; perhaps £750 million in gilt-edged and £500 million in risk securities is a fair guess – although it is only a guess. As with the life offices, however, a rather larger share of current accretions may be going into risk securities than has been usual in the past.

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[1] See, for example, the very valuable pamphlet *The Growth of Pension Rights and their Impact on the National Economy*, prepared for the Institute of Actuaries and the Faculty of Actuaries and published in the spring of 1954.

There is another large group of holdings that some people would call institutional holdings, but that are not 'savings collecting' institutions in a strict sense. For example, it is known that the Charity Commissioners, who operate nearly 75,000 charity accounts, had invested some £125 million by the end of 1953; of this £111 million was in gilt-edged. The invested funds of trade unions are now about £80 million. There are fairly large holdings in the names of industrial and provident societies (which include co-operative societies), and £200 million by the Ecclesiastical Commissioners. None of these holdings, however, seems currently to be growing very fast, and – except in subsidiary degree – they are not vehicles through which savings are canalized. It does not seem any more logical to call them institutional holdings than to call the holdings of industrial companies by that name. The same applies to holdings in private trusts, including the special trusts that have been set up to soften the impact of death duties, as well as ordinary trusts under wills, marriage settlements and so on. Among the more 'institutionalized' of private trust holdings, it is known that well over £1,000 million of investments are held by the trustee departments of the commercial banks and by the Public Trustee; but these should be regarded merely as individuals' holdings that happen to be managed by expert investors. For what it is worth, we will suggest in the next chapter that total gilt-edged holdings piled up in portfolios that do not ever become assessed for death duties (including holdings by industrial companies, foreigners and certain institutions, but not including any holdings set down in Table XI) may have amounted to £1,300 million or more; there will also of course have been sizeable holdings of risk securities. In some of these cases there will have been rules or customs inhibiting risky investment (we will make a brief reference to the operation of the so-called 'trustee list' of investments in the next chapter); and when the income from a trust belongs to one person but the capital to another, the free play of investment decisions is hampered. This is another factor that serves to prevent Britain from getting the flow of risk investment that it needs. But, with rigidly bound marriage or will settlements less fashionable than they were, it is not a growing impediment at the present time.

The Institutions' Stake

Such, then, are the operations of the main institutional investors – so far as we can guess at them. In Table XI a very tentative estimate is made of the holdings of all these different groups of institutions in March 1953. It will be seen that, if our figures are anywhere near to being correct, these institutions probably held virtually the whole of the Government's floating debt – that is, Treasury bills and Ways and Means Advances – outstanding; this estimate is supported by outside evidence, for although some industrial concerns hold a modicum of Treasury

TABLE XI

ESTIMATED INSTITUTIONAL HOLDINGS, MARCH 1953

(£ million)

	Floating debt	*Gilt-edged*	*Other marketable investments*
Government departments	2,000	3,000	Nil
Banking system and discount market	1,800	2.800	Nil
Sterling balances	850	2,000	Nil
Insurance companies	Nil	1,250	1,700
Building societies and investment trusts	Nil	200	650
Non-insurance pension funds	Nil	750	500
Total	4,650	10,000	2,850
Total in issue or quoted on London Stock Exchange	4,714	14,783[1]	12,347[1]

[1] Market values. Nominal values were £16,799 million and £8,825 million respectively.

bills, it is unlikely to be anything important. We have suggested, secondly, that these institutional investors held about £10,000 million of the £14,783 million of marketable gilt-edged in issue at this time; this is a much more shaky estimate – if it is badly wrong it will probably be because our estimates of gilt-edged held in the sterling balances (and to some extent those held by Government departments) have been too large. Finally, it should be noted that the £2,850 million of 'other marketable investments' estimated as held by these institutions cannot be directly compared with the £12,347 million of non gilt-edged securities quoted on the London Stock Exchange at that time, because some of the 'other marketable investments' in the table were foreign securities not quoted in London; we will discuss this point in the next chapter. But it is obvious enough from these figures that the investment institutions do not play nearly as large a proportionate rôle in holdings of risk securities as they do in holdings of Government securities.

Only the very barest summary can be given of the amount of new funds becoming available for new investment in the hands of these institutions in the 'average year' (if there is such a thing). As we have seen, the National Debt Commissioners do not now seem to be making any net additions to their portfolios in most years – and are unlikely to do so until and unless national insurance contributions are increased or the savings banks start to attract new public savings (perhaps by raising the interest rates that they offer on deposits). The Bank of England and the commercial banking system have together had an accretion to their assets of around £100 to £300 million in most of the first seven post-war years. As we shall see in Section II of this book, however, this should not be attributed so much to positive new saving by persons (in the form of larger holdings of Bank of England notes and of commercial bank deposits) as to the influence of inflation; we shall describe in that section how the Bank of England – and to some extent the commercial banking system – can 'create' deposits, more or less out of thin air. Similarly, it is impossible to talk about any 'average' annual accretion of new investible funds through the Exchange Equalization Account or the sterling balances; movements in these depend on fluctuations in the country's balance of payments – and very wild those fluctuations have been in the post-war years.

The investment trusts have not had any significant accretions to their investible funds in the first seven post-war years – and, in any case, they can only get such accretions by floating off one sort of risk security in order to invest in other sorts of risk securities themselves. The building societies have enjoyed an inflow of around £100 to £125 million a year in the late 1940s and early 1950s, but the demand for housing loans has meant that they have been small net sellers of the only stock exchange securities they hold – namely gilt-edged.

The funds of the insurance companies have increased by about £260 million a year in the last few years; something over £35 million a year of these new funds have gone into ordinary shares, £15 million into preference shares, £40 million into debentures and about £40 million into mortgages – but when the war-generated distortion of insurance portfolios in favour of gilt-edged has been partially corrected, it will not be surprising if more of these new funds find their way into Government rather than risk securities. The investible portion of the non-insurance pension funds may be increasing at a rate of over £100 million a year, with perhaps the major share going into risk securities.

In Table XII an attempt is made to summarize this rather diffuse information in handy reference form.The obvious point that emerges from that table is that there are quite a number of funds that can be induced to take up new Government or Government-guaranteed securities if the Government wants them to; but that, apart from the (possibly transient) £100 million or so from the insurance companies and whatever comes in from the non-insurance pension funds, the risk section of the new issue market is in an advanced state of nudism. To this there must be added the point (emphasized in Chapter IV) that private individuals, the traditional risk investors, have probably been net sellers of stock exchange securities since the war – although they have, of course, been enticed in odd moments of optimism to draw funds out of liquid balances to invest on the markets (and have driven prices there sharply upwards whenever they have done so). But the long-term prospect for those who need to raise risk capital certainly does not look bright after reading of this table; there must also be the especial fear that if the insurance companies start to slow down their new investment in risk securities, they may start to slow down that in riskier (i.e. less well established) concerns first. Here, in short, is our familiar problem – the emerging risk capital crisis – rearing its ugly head again.

TABLE XII

INSTITUTIONS' NEW FUNDS FOR THE MARKET

	Annual accretion	*Into Government securities*	*Into other securities*
National Debt Commissioners	About £150 m. in period 1949–51, but falling to nil or deficit in 1954	All of annual accretion	Nil
Bank of England	Dependent mainly on increase in note issue. Around £25 to £75m. in years of inflation 1949–51	Virtually all of annual accretion, but switches between floating and marketable debt in its portfolio of utmost importance	Nil
Commercial banking system	Dependent on increase in deposits, which varies with degree of inflation	Have not actually sought to increase gilt-edged holdings in early post-war years, but have been induced to make some switches out of floating into marketable debt	Nil
Exchange Equalization Account	Gains sterling funds only when Britain is losing gold; loses them when Britain gains gold	Probably all sterling accretions into Treasury bills	Nil
Sterling balances	Increase either when Britain is in balance of payments deficit or when sterling countries are selling gold to E.E A.	Division between marketable gilt-edged, floating debt and other liquid balances uncertain, but clearly liable to vary	Nil
Insurance companies	Annual average £260 m. in 1949–52	Small	About £100 m. a year (excluding overseas securities)
Building societies	About £100 to £130 m. in early post-war years	Nil. Slight net sales as new housing loans have exceeded accretions	Nil
Investment trusts	Very small up to 1952; ploughed back profits only	Virtually nil	Very small up to 1952; ploughed back profits only
Non-insurance pension funds	Probably over £100 m. a year.	Probably under £50 m a year	Probably over £50 m. a year

CHAPTER VIII

THE STOCK EXCHANGE

The investment institutions discussed in the previous chapter are savings collecting agencies. The Stock Exchange does not collect or generate savings. It is merely a market, on which variable price securities are bought and sold. The more efficiently the Stock Exchange functions the more readily can those with savings on hand buy variable price securities, and the more easily can they sell them when they need to. The Stock Exchange is therefore the hinge around which the whole long-term capital market turns.

There are twenty-three stock exchanges in Britain; we will list them and discuss them further in Chapter XII. But the most important, and the only one with which we shall be concerned in this chapter is, of course, the London Stock Exchange, which is situated in Throgmorton Street in the City. At this writing there are some 3,500 members of the London Stock Exchange, divided into 466 firms. Just over two-thirds of these firms are brokers and just under one-third are jobbers.

Brokers act as agents for the public, buying and selling their clients' shares on commission and at those clients' orders. Any individual who is a serious investor will be the client of a stockbroker. Less serious investors are often not clients of individual stockbrokers, but will tell their bank which shares they wish to buy or sell; in this case the bank will pass on the order to buy or sell these shares to its own brokers – we need not enter here into the vexed question of how the commission is split up between the bank and the brokers – but the point is of course that an investor who invests in this way does not have the direct benefit of a stockbroker's specialist advice.

Jobbers, on the other hand, deal on their own account; they do not have clients. A jobbing firm will usually specialize in one or more fairly narrow sections of the market (say, in oil shares or rubber shares) and its representative will take up his place each day on the part of the floor of the Stock Exchange in which these shares are sold and bought. A broker, who has an order from one of his clients to buy or sell a particular share, will then approach the jobbers and make an enquiry after the price of that share; the broker will not say at that stage whether his client wants to buy or to sell. The jobber will quote two prices back at him – say 19*s* and 19*s* 6*d* – meaning that he is willing to buy at the lower price and sell at the higher. It is from this spread between buying and selling prices that the jobber makes his income or 'turn'; or rather – to be more strictly accurate – he will make his income or turn by quoting a selling price slightly higher than the price at which he thinks he can get the security himself from elsewhere, and a buying price slightly lower than he thinks he can get for the security on resale. The size of the turn that the jobber demands varies from share to share. To quote Mr Harold Wincott 'On a relatively small group of highly marketable shares, the turn may be as low as 1½*d* on a share standing around 20*s*, i.e. around ⅝ths of 1 per cent. But a turn of twice as much is more common and in quite a number of instances, notably in low-priced shares which are not the best of markets, turns of between 8 and 16 per cent may be encountered.'[1]

If a broker is satisfied with the price quoted – that is to say, feels confident that another jobber will not offer him better terms – he will make his order there and then. His word is his bond. The broker and the jobber will make a note of their bargain and it will be settled by the transfer of cash and stock by the end of the current stock exchange account: most stock exchange 'accounts' are of two weeks' duration.

What are the virtues of and what are the criticisms that can be levelled against this system? The prime virtue of the London Stock Exchange is its quite unassailable integrity. The Stock Exchange has an insurance scheme that ensures that no client will lose his money as a result of the financial failure of any jobber or other member firm. It has a council that cocks a puritan eye to make quite sure that there is no 'funny business' in a field where 'funny business' would often be possible. That much can be said with resounding confidence. Some people with no knowledge of the City of London sometimes assume that the Stock Exchange is probably inhabited by sharks. In fact it is inhabited by a strange mixture of skilled professionals, retired military gentlemen and the sort of people one always finds watching a Test match from the pavilion at Lords' cricket ground; sometimes – and to a surprising degree – the three groups overlap. But nobody with the smallest acquaintance with the 'House' can doubt that honesty, pride in the profession and a friendly club atmosphere are the virtues that hang over all. Nobody can say how this has come about, and some people may doubt whether it is a good thing; but the reader who has a mental picture of narrow money-making, stuffiness and starch has got the whole atmosphere of this typically British institution wrong.

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[1] See 'Are Jobbers Outmoded?' by Harold Wincott, *The Banker*, March 1949. This special issue of *The Banker* was devoted to a study of 'The Future of the Stock Exchange', and was probably the best symposium on the subject that has appeared since the war.

What, now, of the criticisms? One criticism that is often levelled is against the system of dealing itself. The jobber system is peculiar to London. In other markets, such as New York, brokers or dealers buy and sell directly from and to each other. The historical argument for the jobbing system is that jobbers, by holding stock on their books, ensure that there are ready supplies to meet buying orders and a ready buffer to accept selling orders – thus preventing prices from soaring or slumping unduly at times of pressure; after statistical assessment of recent price movements, however, some analysts deny the validity of this argument under modern conditions. The real argument for the jobber system seems, therefore, to be simply that at present it exists; it is not proved that wholesale scrapping of the system would make dealings any cheaper for the investor, and such a wholesale change would cause a lot of unnecessary disturbance at this time.

There does, however, seem to be some case for urging that three improvements should be made in the mechanics of the Stock Exchange system. In the first place jobbing and stockbroking firms are nearly all private businesses or partnerships; attempts have been made to turn some into private unlimited liability companies, but with scant success. Now, of course, a normal type of limited liability company would be an inappropriate form of organization for people who work in such a delicate financial field as jobbers; but the squeeze exerted by taxation on small businesses – a recurrent theme throughout this book – has necessarily left them with capital that is often insufficient if they are to do their proper job. They do get some temporary outside finance by borrowing from the banks, but it seems a pity that Stock Exchange Rules (drawn up as part of the House's commendable puritan tradition) prevent them from raising some permanent outside capital. They might get this outside capital from institutional investors who could be entitled to a fixed interest on their loans (the service of which should be a first charge on profits) and a share in any residual profits after that.[1]

The second reform that has been suggested is that brokers might enter on a register in the Stock Exchange their interest in buying or selling certain securities in which little business is currently being transacted; and thus come together to deal directly with one another in this way. When a jobber is asked to quote a price for a little-known security of which he has no ready supply, he naturally tends to quote a wide turn in order to cover himself. He will have to buy the security himself from somewhere else, and in the case of such securities he therefore performs only an expensive middleman function.

The third reform that may be desirable is for some system of central book-keeping for the Stock Exchange. At the moment the sealing of a bargain involves setting clerks at work in widely separated offices, and messengers marching back and forth carrying securities and documents and cheques; the Stock Exchange could probably cut its clerical costs enormously if it had some sort of central clearing house, with clerks all working under one roof. One difficulty, of course, is that such a rationalization would make some old and faithful servants of the individual firms redundant; it would be a delicate scheme to introduce. It should be emphasized, too, that those who advocate it are not in any way advocating a restriction of competition between firms. Stockbrokers already work to a fixed scale of commissions, but compete with each other in services offered and quality of advice. Jobbers should compete with each other vigorously in the prices they quote, but there has been some understandable – though regrettable – reaction among them against cut-throat competition in recent years.

These procedural reforms might do something towards cutting the costs of dealing for the investor, but they would not by themselves attract many new investors into the field. The main criticism that can be levelled against the Stock Exchange today is precisely that it has done very little to attract new investors in. Figures that have already been quoted in this book have shown that the richer section of the British people, which has traditionally provided most customers for the Stock Exchange, is being progressively squeezed by high taxation. It has also been pointed out that the poorer section of the community, which is having income re-distributed towards it, is not able to put so much of its capital at risk. One answer to this problem may lie in the increase in investment trusts and unit trusts, which allow small investors to spread their risks more evenly when embarking upon stock exchange investment. But those trusts would grow up of their own accord if there was a demand for them. It is the Stock Exchange's prime duty to do more to activate the pool – admittedly it is probably now an inadequate pool – of small investors that exist. The rest will follow after that.

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[1] For details of this and other possible systems, see Wincott, op cit.

The answer to this problem does not necessarily lie in a proliferation of hundreds of stock exchange agencies – as a type of showroom – up and down the country. The most obvious step that should be taken is a co-operative effort between the Stock Exchange and the ten thousand existing outlets that should – for the country's good – serve as shop windows for securities; these, of course, are the ten thousand bank branches spread across the country. At the moment many bank managers seem to allow their customers' accounts to run up to surprising levels before they advise investment, and any suggestion that they should flaunt loud notices showing 'the yield on certain selected equities today' or even keep more investment brochures for customers to browse through is apt to be regarded with horror.

Several reasons can be put forward for this comparative failure – the banks' apprehension about getting into a position where they might seem to be giving too much risky investment advice to their customers (advice that would obviously sometimes go wrong) is one of them, and haggling over the share of commission between banks and brokers may be another. But the main difficulty seems to be that, as the Stock Exchange and banking system are now organized, a stream of small-scale orders of this sort would not necessarily be remunerative to those taking the orders. The more seems to be the need therefore for stock exchange economies through centralized book-keeping and other means.

This leads us on to the problem of stock exchange advertising. At the moment, as part of the puritan rules of the House, stock exchange firms are not allowed to advertise; this rule is very strictly enforced indeed. Most outside observers of the City must feel that the time has come for this rule to be relaxed; advertising is permitted to stock exchange members in America, and it does not seem to have led to any obviously undesirable consequences there. There is also a very strong case for more effective central advertising by the London Stock Exchange itself, as a body. The present Council has taken some tentative steps in this regard. In 1953 it opened a gallery over the House which can be visited by members of the public who wish to look on at brokers and jobbers at work; and it has also carried out a 'mock' performance on television and sponsored some brochures and a book. But it is a fair criticism that its attitude has been defensive. Council spokesmen always seem eager to stress that the Stock Exchange is a harmless organization; they explain that very little 'speculation' (whatever that means) takes place and that many of their customers are widows, orphans, charities and insurance companies who have been entrusted with the savings of small savers. The gospel that should go out instead is that here – on this crowded floor in Throgmorton Street – is the mechanism whereby the savings of the British people flow into the most productive forms of long-term investment in British industry; and it is on productive investment in British industry that the economic future of this country will depend.

GLOSSARY OF STOCK EXCHANGE TERMS

It may be convenient at this stage, in order to give readers a clearer idea of how the Stock Exchange works and to enable them to understand the jargon of stock exchange reports, to compile a short glossary of stock exchange terms.

(1) *Bank Advances to Stock Exchange Firms.* Stockbrokers may borrow from the banks, principally in order to meet commitments to jobbers for securities bought by clients who have not yet sent in their money; this borrowing used to be fairly heavy before the war, but there have been voluntary restrictions on it since the war to discourage speculation. Jobbers, on the other hand, naturally borrow fairly heavily from the banks in the ordinary course of their business.

(2) *Bargains.* Each day in *The Times* and other newspapers, there is printed a list of 'bargains marked' – i.e. deals done – on the Stock Exchange. It should be emphasized, however, that only one mark is recorded in any one security at any one price, so that this list does not provide a detailed guide to the extent of turnover. Nevertheless, when a lot of bargains are marked, that is a sign that the Stock Exchange has had a hectic day, and when few bargains are marked, that is a sign that it has had a dull day.

(3) *Bears, Bulls and Stags.* These animals are sometimes called 'inmates of the Stock Exchange zoo'. A 'bull' is an investor who buys a share expecting it to rise; a 'bear' is one who sells a share expecting it to fall; and a 'stag' participates in a new issue in the expectation that once dealings in that new issue start on the market, the market price will be higher than the issue price. We shall have more to say about stags in Chapter XII.

(4) *Contango.* We have already seen that investors normally settle with their brokers, and brokers with the jobbers, by the end of each fortnightly account. But if, say, a bull has bought a share expecting a rise in price, and finds that by the end of the account that rise has not yet occurred, he may make arrangements to 'carry-over' his transaction (i.e. delay paying for it) if he is willing to incur what is known as a 'contango' rate of interest. This rate depends partly on the general rate of interest and partly on the supply of shares; if that supply is very short, so that sellers do not want to deliver shares, the rate of interest may be negative – in that case it is called a 'backwardation' rate of interest instead of a 'contango' rate.

(5) *Clerks.* Clerks in stock exchange firms are divided into 'authorized' and 'unauthorized' clerks. An authorized clerk is simply one who is allowed to go on to the floor of the Stock Exchange itself, while unauthorized clerks work in the firm's own office.

(6) *Options.* Before the war an investor who thought that a certain share was going to rise in price used to be allowed to exercise what was known as a 'call' option. He would pay a stated sum to his broker which would give him the right to buy a certain share at a fixed price at the expiration of a certain period (usually one to three months). If the shares fell in price he would not exercise his option, but his loss would then be restricted to loss of the option money he had paid; if they did

rise in price he could exercise his option at his fixed price and then resell at a profit. A 'put' option was the reverse of a 'call' option; here the investor bought the right to sell at a fixed price certain shares that he expected to drop in value. A 'double option' – also called a 'put-and call' option – gave the investor the right to either buy or sell at a fixed price, but this was a relatively unusual method of hedging against violent but uncertain fluctuations in any particular security. Option dealings have not been allowed since the war, apparently because both the authorities and the Council of the Stock Exchange are afraid that outside critics would regard these sensible hedging devices as an undesirable form of speculation.

(7) *Take-over Bids*. Since the war many companies have paid out only a very small part of their profits in dividends. As share prices usually reflect dividends paid, the market value of most shares is therefore below the real value of the assets, whose ownership they represent; we have already seen that this is one of the reasons why total personal wealth is below total national capital. The situation has therefore arisen whereby certain speculators who buy up the majority of low-priced shares in certain companies can get control of businesses making very large profits indeed – and then arrange to pay out more of those profits in dividends to themselves. A variation of this situation arises when a company has some very valuable buildings – say, buildings that are used as hotels in the centre of London – which are not making very high profits in their present use, but could bring in a lot of money if they were sold off or put to another use. Anybody who buys shares with the intention of gaining control of a company for these purposes is said to be making a 'take-over' bid.

The authorities have frowned on take-over bids, and they have asked the banks not to lend money to those concentrating on them; they have also asked the insurance companies and other financial institutions not to help the process along (for example, by buying the buildings that are sold off by successful takers-over). But out-and-out condemnation of take-over bids would be a mistake; if existing boards of directors are not putting their assets to the most economic and profitable use, it is good that they should be shaken out of their lethargy. There is, of course, the difficulty that when certain people are known to be big take-over specialists, they can associate their names with almost any share – and be fairly sure that those shares are likely to rise in price (giving them a straightforward capital profit); if Mr X is known to be in the market for a particular share, everybody else comes in on his coat-tails. There are also possibilities of undesirable and deliberate leakages or even false rumours, as well as of undesirable and deliberate 'gutting' of company assets, attached to this whole business of take-over bids. But, in essence, the trouble is really a reflection of a familiar economic experience: whenever artificial encumbrances, such as voluntary dividend restraint, are injected into a free market, the consequences are always troublesome and far-reaching.

(8) *Trustee Stocks.* The trustee list on the Stock Exchange contains British Government and Government-guaranteed stocks, some (though not all) Colonial and Dominion Government stocks, most British corporation and county stocks and a few other driblets. These are the securities in which trustees may invest trust funds, with the sure knowledge that they will not be called to account if the investment goes wrong. Although the deeds under which most trustees operate nowadays allow wider latitude than this, many people think that – from a national point of view – the existence of this trustee list is a mistake. It induces an important band of investors to be ultra-cautious, at a time when the country is crying out for risk investment.

WHO HOLDS STOCK EXCHANGE SECURITIES?

We have now come to the end of our assessment of 'who saves?' and of the nature of the Stock Exchange. Since many of the estimates of savings and capital we have made have not been published before – and since statistics about the Stock Exchange are so shockingly sparse – it seems worth-while to round off this chapter with a summary of the very broad conclusions that may be drawn about the distribution of holdings of stock exchange securities in general. In doing so, of course, it must be emphasized again that the estimates that follow are very rough ones; but until some research body spends a lot of time and money on more detailed investigations, they are the best we can do.

We must begin by assessing how many stock exchange securities there are for people to hold. At the end of March 1953 the market value of all shares quoted on the London Stock Exchange was £27,150 million. In Table XIII we have divided these, very roughly, into five categories. It will be seen that there were some £14,800 million gilt-edged, some £550 million of British municipal stocks and other near gilt-edged, some £900 million of overseas Government and overseas municipal bonds, and around £11,000 million of company shares and debentures. These £11,000 million of company shares and debentures we have further subdivided – very roughly – into about £3,150 million of securities of concerns operating mainly overseas and £7,850 million of companies operating mainly in Britain.

Four points need to be made about this valuation. First, it is of course false to assume that all these £27,150 million of securities quoted on the London Stock Exchange were held by British investors; necessarily, overseas investors held many of them – especially the securities of concerns operating within their own countries. Secondly, British investors can buy through the London Stock Exchange many securities that are quoted in New York or other recognized stock exchanges throughout the world; they are not restricted to the £27,000 million odd quoted in London. Under current exchange controls, however, British investors can generally only pay in sterling for their securities (although if they own an existing American security, they can sell it for dollars in New York and use these dollars to buy another American security). Apart from these 'switching' operations, an Englishman buying an American security must generally buy it from another Englishman for sterling, and thus pay a premium over the price at which he could obtain that security for dollars in America.

Thirdly, it may be asked how many of the £11,000 million odd of company securities quoted in London were debentures, how many preference shares and how many ordinary shares. The answer – a rough, order-of-magnitude answer – seems to be that rather less than £1,000 million were debentures, rather less than £1,500 million preference shares and £9,000 million ordinary shares (although this includes some ordinary shares that were, by custom, much more of a fixed interest type than of a really variable dividend type). Fourthly, it may be asked how many companies there were represented among these £11,000 million odd of shares. We saw in Chapter V that the *Economist* traced just under 2,500 companies that published balance sheets in 1952, with a nominal value of shares and debentures of just over £3,500 million; we can now see from Table XIII that the total nominal value of London-quoted company shares (with their market value of £11,000 million)

TABLE XIII

SECURITIES QUOTED ON LONDON STOCK EXCHANGE, MARCH 1953

(£ million)

	Nominal value	*Market value*
Domestic gilt-edged		
British Government stocks . .	13,950	12,350
Guaranteed and nationalization stocks	2,850	2,400
	16,800	14,800
Domestic near gilt-edged		
British municipal and county stocks	400	350
Other near gilt-edged . . .	250	200
	650	550
Overseas government and municipals		
Dominion and Colonial . .	700	650
Foreign stocks and bonds . .	1,900	250
	2,600	900
Concerns operating mainly overseas		
Gold, metal and other mines . .	400	1,400
Oil	250	850
Railways, tramways and public utilities	700	800
Rubber, tea and coffee . . .	100	100
	1,450	3,150
Concerns operating mainly in Britain		
Commercial and industrial . .	2,500	4,900
Iron, coal, steel and shipping . .	300	550
Breweries and distillers . . .	200	600
Banks, insurance, financial and investment trusts . . .	900	1,800
	3,900	7,850
Total	25,600	27,150

N.B.—Because of the very rough value of the estimates in this chapter, these figures are deliberately rounded, and are not intended to add up to the exact total shown.

was around £5,350 million. Probably the missing £1,850 million of nominal capital was split up among another 2,500 odd (mostly smaller) companies, making about 5,000 companies in all with securities of some kind quoted on the London Stock Exchange.

In trying to assess who holds all these stock exchange securities we will be mainly concerned with the distribution of holdings as between institutions and persons. We discussed most of the institutions in the last chapter. The figures for institutional holdings written into Tables XIV and XV below are drawn direct from that chapter.

But what about persons? It seems probable that only about 1,250,000 to 1,500,000 of British families hold stock exchange securities. The Oxford Survey of liquid assets, to which reference has already been made, estimated that about 5½ per cent of the 22 million 'income units' in Britain derived part of their income from holdings of stock exchange securities; this again works out at about 1,250,000 income units, but the authors of that survey believed that they had failed to get an entirely accurate representation of larger property owners, among whom shareholders abound. For what it is worth that survey suggested that approximately 28 per cent of those with gross incomes between £1,000 and £1,500 a year, and just over 51 per cent of those with gross incomes of £2,000 a year held some stock exchange securities. They also found that more older people held stock exchange securities; thus about 9.6 per cent of those aged 65 and over and about 10.3 per cent of those classified as 'retired, etc.' had some stake in this field.

We have three other small clues to go upon to trace the broad pattern of personal ownership of shares. First, we estimated from the death duties figures in Chapter IV that persons probably hold rather over £13,500 million of variable price securities; about £2,500 million may have been unquoted shares (e.g. private companies), so personal holdings of quoted securities may be rather over £11,000 million. Secondly, a parliamentary question in 1952[1] elicited the fact that about 40 per cent of company dividends and debenture interest normally goes to personal surtax payers; since some company shares are held by institutions, this must mean that over 50 per cent of personally held company shares are owned by those with gross incomes over £2,000 a year. Thirdly, we have some Inland Revenue figures to show that in 1949–50 rather over 50 per cent of all interest and dividends (of all kinds) went to those with gross incomes over £2,000 a year, rather over 25 per cent to those with incomes between £500 and £2,000 a year and rather over 20 per cent to those with incomes under £500 a year.

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[1] See *Hansard*, October 21st, 1952.

Interpolating from the Oxford Survey and Inland Revenue figures, therefore, we can now make some bold estimates. The best guesses must be that:

(1) Somewhere between 500,000 and 600,000 people with gross incomes under £500 a year hold some stock exchange securities, with a grand total of somewhere between £2,000 and £2,500 million. Many of these will be elderly and retired people.
(2) Somewhere between 500,000 and 600,000 people with gross incomes between £500 and £2,000 a year may hold some stock exchange securities, with grand total somewhere between £2,500 and £3,000 million.
(3) Somewhere between 100,000 and 150,000 people with gross incomes over £2,000 a year may hold stock exchange securities, with a grand total between £5,500 million and £6,000 million.

These guesses unfortunately confirm the suggestion that it has been the rich – the declining rich – who have been the principal personal investors in the Stock Exchange in the past.

GILT-EDGED AND NON GILT-EDGED

We can now turn to examine the probable distribution, as between persons and institutions, of the different types of stock exchange securities. Table XIV opposite sets down our estimates about holdings of gilt-edged at the end of March 1953. The basis for the estimates of institutional holdings was discussed in the last chapter, and that for the (very rough) estimate of personal holdings in Chapter IV. The estimates for 'public joint-stock companies', etc. are derived from the *Economist* of April 8th, 1950. The *Economist*'s figures excluded Government-guaranteed securities (as distinct from direct Government obligations) but they also referred to a period when market prices were higher than at end March 1953 so this distortion may come out in the wash. The last item in the table – the £1,000 million odd for 'others' – is a pure residual. Outside estimates of the holdings of trust funds that do not come into the death duties figures, of foreign holdings other than those in the sterling balances and the composite holdings of odd concerns such as charities, churches, etc. have usually added up to a bigger total than the £1,000 million we have set down; but once again it must be emphasized that our guesses – probably especially for persons and for gilt-edged in the sterling balances – are subject to very wide margins of error.

TABLE XIV

ESTIMATED HOLDINGS OF GILT-EDGED IN MARCH 1953

(£ million)

Government departments	3,000
Banking system and discount market	2,800
Overseas sterling balances	2,000
Insurance companies	1,250
Non-insurance pension funds	750
Building societies and investment trusts	200
Total above institutions	10,000
Persons	3,500
Public joint stock companies	300
Others (including other trust funds, private individuals abroad, etc.)	1,000
Approx. Total	14,800

To trace the holdings of the £12,450 million odd of securities other than gilt-edged quoted on the London Stock Exchange at the end of March 1953 we must go through something of an unscrambling exercise. Our guiding lights here must be Table XIII, which shows the total nominal and market values of securities quoted on the London Stock Exchange in March 1953 (with the figures rounded off); and Table XV whose method of compilation will be explained as we progress.

The second category in Table XIII, after gilt-edged stocks, consists of some £350 million of British municipal securities and some £200 million of other 'near gilt-edged' (including the securities of certain public boards, securities issued under the Trade Facilities Act, etc.). If we treat the death duties figures in the arbitrary manner we used in Chapter IV, this would suggest that there were some £350 million of British municipal securities in private hands; it seems probable, however, that this is an overestimate, because we traced some £100 million of 'British municipal securities or loans on public rates' among the assets of the insurance companies (see Chapter VII), and there are obviously some other institutional holdings of this type of security. There is some doubt about how the securities we have called 'other near gilt-edged' would be classified in the death duties figures and in institutional portfolios; but the amount untraceable here is too small to worry about. We have therefore put these figures – quoted 'near gilt-edged' of £550 million and apparent personal and insurance holdings of £450 million – down in Table XV without correction.

Our next category in Table XIII consists of £650 million of securities of Dominion and Colonial Governments and municipalities that are quoted on the London Stock Exchange. Obviously, however, British residents own many Commonwealth Government securities that are not quoted in London; while, contrariwise, many more of these stocks that are quoted in London are actually owned overseas. We have a rough check here, however, from the fact that the Bank of England publishes figures (much in arrears) for the nominal value of overseas securities 'quoted on or otherwise known to the London Stock Exchange' that are held by British residents. It estimated the nominal value of such Commonwealth Government and municipal securities held by British residents in 1951 at £509 million, with an annual interest yield of £17 million. To judge from the ratios shown between nominal and market values in Table XIII, the market value of these holdings may have been around £470 million in March 1953 which would indicate that about £180 million of the £650 million odd quoted in London was held abroad. Closer subdivision of the figures already cited in Table III in Chapter IV would suggest that personal holdings of Dominion Government and municipal securities may be around £380 million; and Table X in Chapter VII showed that the holdings of these securities by insurance companies established in Britain were around £150 million (and insurance companies established in the Commonwealth countries themselves naturally held a much larger portfolio of them). In addition, perhaps £10 million odd of the £90 million odd of Commonwealth securities that are held by British investment trusts will be held in Commonwealth

Government or municipal loans (although this is a pure guess). These figures, if taken at face value, would add up to traceable British holdings of about £540 million of Commonwealth Government and municipal securities. This may seem odd since we have suggested that only about £470 million of the £650 million odd (in market values) of such securities quoted on the London Stock Exchange were held by British investors; and there must have been some other British holders of such securities beside persons, insurance companies and investment trusts. But since many Dominions' securities (especially Canadian securities) that are held by British investors are not quoted in London, the figures in this part of Table XV look a reasonable guess.

Even greater difficulties lie in the way of an assessment of holdings of foreign government stocks and bonds. It will be seen from Table XIII that the nominal value of such stocks and bonds quoted on the London Stock Exchange in March 1953 was no less than £1,900 million; but so many of these were moribund (such as the bonds of communist countries) that their total market value was only about £250 million. Some defaulting debtors, notably the Germans and Japanese, however, have recently started to pay interest again. The Bank of England's figures put the nominal value of foreign-quoted Government and municipal bonds held by British residents at £260 million in 1951, or only 13½ per cent of the nominal value of such bonds then quoted on the London Stock Exchange; the Bank traced an interest yield of only £3 million per annum, which would suggest an aggregate market value well below £100 million. A subdivision of the figures in Table III in Chapter IV estimates personal holdings of these bonds at around £100 million in 1950–1. The holdings of foreign government and municipal securities by insurance companies established in Britain (see Table X in Chapter VII) were £196 million at the end of 1952, but many of these will have been American Government securities not quoted in London; the same applies to part of the holdings of foreign government securities by British investment trusts. Much of the foreign exchange reserves held by the Exchange Equalisation Account will also have been in American Government securities. All these figures are too much of a hotchpotch for any sensible estimate to be based upon them.

We come now to the category that we have described in Table XIII as 'Concerns operating mainly overseas'. Securities in this category that were quoted on the London Stock Exchange had a nominal value of £1,450 million and a market value of £3,150 million; but, once again, many of these will have been held abroad. The Bank of England's figures for 1951 showed the nominal value of shares of gold mines, metal mines and other mines held by British residents as just under £190 million, which would suggest a market value of rather over £660 million at the end of March 1953; the Bank's estimate for British holdings of oil shares was just over £150 million nominal (1953 market price, say rather over £500 million); for British holdings of shares of overseas railways, tramways and public utilities, a nominal value of around £375 million (1953 market value, say £425 million); while the Bank's figure for the nominal value of British holdings of shares of rubber, tea and coffee producers was almost exactly equal to the nominal value of all such shares quoted on the London Stock Exchange (1953 market value, say £100 million). These would add up to grand totals for this broad category of just over £800 million in nominal values and just under £1,700 million in market values; and would thus suggest that between 40 and 50 per cent of the London-quoted securities in this category may have been owned by overseas investors. This does not seem too high a percentage. South African investors naturally hold many of the shares in their own gold mines and so forth.

Our final category in Table XIII – 'Concerns operating mainly in Britain' – is something of a misnomer. For it would not be surprising if (at a guess) as many as 10 or 20 per cent of the concerns even in this category operate mainly or even wholly overseas. But if we disregard this complication for a moment, assume that all the £7,850 million of securities (by market value) in this category might be held in Britain, and then add to them the £1,700 million odd in market value of shares of 'concerns operating mainly overseas' that we suggested above might be held by British investors – then that would give us a maximum holding for British residents of £9,550 million of all quotable industrial securities. These are the figures set down in column 2 of Table XV.

In Chapter VII we traced £1,051 million of ordinary shares, preference shares and debentures held by insurance companies

TABLE XV

ESTIMATED TRACEABLE HOLDINGS OF QUOTABLE NON-GILT-EDGED HOLDINGS IN BRITAIN

(£ million in market values)

	1 *Total quoted on London Stock Exchange at end March 1953*	2 *Total of (1) that may have been held by British investors*	3 *Apparent personal holdings (see Table III)*	4 *Insurance company holdings*	5 *Investment trust and pension fund holdings*	6 *Total of cols. (3) (4) and (5)*
Domestic near gilt-edged .	550	550	350	100	(N/a)	450
Commonwealth Government and municipal securities .	650	470	380	150	(10)	540
Foreign Government stocks and bonds .	250	(less than 100)	100	200	(N/a)	(N/a)
Industrials (mainly overseas) . .	3,150	1,700	670	1,050	(say, 1,000)	8,850
Industrials (mainly home)	7,850	7,850	6,150			
Total . .	12,450	(approx. 10,650)	7,650	1,500	(say, 1,000)	approx. 10,150

established in Britain (although some of these will have been securities that are not quoted on the London Stock Exchange); and we also traced over £650 million of non-British Government securities held by British investment trusts (to which the same proviso applies), and suggested that non-insurance pension and superannuation funds might hold about £500 million. We should add to the insurance holdings the industrial shares held by the insurance offices and societies shown at the bottom of Table X in Chapter VII; but as the £1,051 million we have already cited certainly included some shares that are not quoted in London we can ignore this addition. From the total of just under £1,200 million of holdings of non-British Government securities by investment trusts and non-insurance pension funds we must certainly make some subtractions for shares that are not industrial shares quoted in London; we have put down £1,000 million as a maximum for these London-quoted industrial shares, but it is probably an over-estimate.

In Chapter IV a division of our estimates, from analysis of death duties figures, suggests that private persons in this country might hold about £8,650 million of British industrial securities (from which, at a guess,[1] about £2,500 million may be deducted as shares of private companies and other unquoted securities) and around £670 million of overseas industrial securities. Thus, in Column 6 of Table XV, institutional and personal holdings of quoted industrial securities are put at £8,850 million, and to them of course must be added the investment holdings of industrial companies and 'others' (of the sort that we discussed when analysing gilt-edged holdings in Table XIV). This total of £8,850 million plus non-traceable holdings of quotable securities in Britain goes against the estimate of £9,550 million minus for total potential British holdings of actually quoted industrial securities that we suggested as a maximum in Column 2 of Table XV.

Similarly, about £10,650 million of the £12,450 million of all non-British Government securities quoted in London may be held in Britain (and £1,800 million held abroad); our total of the holdings of marketable non-British Government securities by persons, insurance companies, investment trusts and non-insurance pension funds comes to £10,150 million (Column 6 of Table XV), but we have seen that this total includes some overseas government stocks that are not London securities. Once again, it should be emphasized that the figures shown in this chapter are compiled in a necessarily unsatisfactory manner; but they seem to be the best guesses that can be made at the broad pattern of holdings. Tables XIV and XV are a rough guide to possible magnitudes, but that is all. If we are right, however, in 1953 private British persons held only some £3,500 million of the £14,800 million of British gilt-edged, while the big investment institutions held some £10,000 million. On the other hand, private British persons seem to have held some £7,650 million of the £12,450 million of non gilt-edged quoted in London, while the big investment institutions held only some £2,500 million. In view of the squeeze on personal investors these figures – which indicate that the institutions are the important holders of gilt-edged but that private individuals are still the most important holders of risk securities – carry important implications for the capital market.

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[1] Figures given in the Inland Revenue Report for 1952–3, suggest that about 7 per cent of all assets assessed for death duties (i.e. £2,100 million on our basis of estimate) were private company shares.

CHAPTER IX

FINANCE FOR INDUSTRY

I. FIXED CAPITAL FOR THE SMALL BUSINESS

The time has now come to examine the problems of capital provision for individual businesses and industries. We will start with the egg before the hen, that is to say, with the problem of finding fixed capital for the new and the small business. By small businesses we mean, broadly, businesses that are too small to hope to be able to raise capital by public issues of shares that are quoted on a stock exchange. All unincorporated businesses and private companies, of course, suffer from a legal disability in this regard; the real difficulty, however, is not one of legal forms (which can be changed), but of cost.

As a very broad generalization, it can be said that any company with net assets below about £150,000 must find a new issue on to a stock exchange exorbitantly expensive; and it is not easy to float off an issue until assets are considerably higher still. The main reason for this is not simply that some charges involved in a flotation are more or less fixed, whatever its size. The real trouble is that when a company is so small that only a handful of shares in it can come in issue, the market in these shares must necessarily be narrow. Investors in them therefore cannot be guaranteed the opportunity for ready sales (i.e. the opportunity for liquidity), and they have to be compensated with a high yield. Although the yields that have to be offered vary from company to company and from industry to industry, all estimates of the cost of flotation of small issues have emphasized this[1]; but they do not tell the full story, for that could only be told by an analysis of the issues that have not been floated because they have been frightened off by the prospect of high costs.

It was with these considerations in mind that the famous report of the 'Committee on Finance and Industry' (the so-called 'Macmillan Committee') in 1931 argued that there is a gap in financing facilities for small- and medium-sized businesses in Britain – a gap that is filled by the new issue market for their larger *confrères*. One of the topics we will have to discuss in this chapter is whether this 'Macmillan gap' does in fact exist. We can start off, however, with the assumption that, whether there is a gap or not, there is certainly a barrier. On one side of the barrier are small firms that cannot raise capital on new issues, and on the other larger firms that can. The first question we must face is: How many businesses are there on the small side of the barrier, and what is their economic importance?

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[1] See, for example, R. F. Henderson (1951), *The New Issue Market and the Finance of Industry* (Bowes & Bowes), 172 pp., price 25*s*.

There can be no complete answer to these questions, and exploration must be brief. Tax returns in 1949–50 suggested that the main stamping grounds of businesses not registered as companies were retail and wholesale distribution (with 500,000 small businesses), farming and fishing (350,000), building (125,000), professional services (150,000), 'other services' (250,000) and clothing, the food trade and road transport (with 100,000 between them). Outside these eight fields of enterprise, companies reign supreme; but even here (as we saw in Chapter V) about 251,000 of the 262,500 registered companies in Britain were private, instead of public companies. Of course the public companies are much bigger than the private ones (the total nominal paid-up capital of the 11,500 public companies in Britain in 1952 was £3,970 million, against £2,330 million for the 251,000 private companies), but this should not obscure the fact that the smaller firms still play a very significant part in Britain's economy. The industrial census of 1948 revealed that 116,000 of the 140,000 manufacturing establishments in Britain employed less than 50 workers each. Admittedly the other – and biggest – 24,000 manufacturing concerns employed more than 80 per cent of the workers in manufacturing industry; but the rôle of the bigger companies in distribution, in agriculture and in service industries is much smaller. At a guess, the number of workers who earn their livelihoods in all private enterprise concerns on the small side of the 'Macmillan barrier' is probably rather greater than those in private enterprise concerns on the bigger side of the barrier. Since companies on the bigger side of the barrier – almost by definition – generally employ more capital per worker, this does not necessarily mean that more than half of private enterprise production is carried on in small concerns. But probably the proportion is higher than most people think

Sources of Finance

This, then, is the field we must explore in this chapter. The sources of capital open to businesses on the small side of the new issue barrier can best be considered under nine heads:

(1) Initial finance;
(2) Ploughed back profits;
(3) Renting of buildings;
(4) Mortgages;
(5) Renting of equipment through hire purchase;
(6) Bank loans and other working capital;
(7) Private placings of shares not brought on to a stock exchange;
(8) Other forms of long-term loans;
(9) Specialist financing institutions.

We will see that there are no reliable statistics available of the importance of most of these forms of finance, and this must hamper any investigation into the existence or extent of the 'Macmillan gap'. But since the specialist financial institutions that will be considered under the ninth of the heads listed above have been set up precisely in order to fill this so-called 'gap', we will be able to glean some information from examination of the demand for their services. The first eight sources of finance can now be briefly discussed.

Under the first head, anybody setting up a new small business from scratch must usually do so with his own money or money lent to him by a relative or close friend. There are a few exceptions. Some established public companies may still lend capital to a promising employee who wants to branch out on his own in a line that will be useful to them for sub-contracting purposes, and there are a few people who will put money into a small business (as sleeping partners) through solicitors or in answer to advertisements in *The Times* and so forth. But the numbers of these willing angels are small – much smaller, probably, than forty or fifty years ago when investment in local enterprises through local solicitors was fairly common (though it varied from area to area). This, however, is part of the risk capital problem that obviously cannot be cured by the establishment of new financial institutions, nor by a change in the lending habits of old ones. The banks and other lending agencies obviously cannot lend money to untried businessmen without security; they would very soon go bankrupt if they did.

The second source, ploughed back profits, is, of course, the traditional source of growth for a small concern. The Victorian craftsman who set up his own business, went on living at or a little above a craftsman's standard of consumption, and ploughed back profits until his business grew into an industrial giant, was in many ways the architect of Britain's modern economic greatness. But taxation has done much to kill his kind today.

We discussed the problem of the weight of taxation on business profits in Chapter V, and here we need only underline two reasons why the problem is especially acute for small businesses. First, if the business is an unincorporated one, the owner's earnings will be mulcted of surtax as soon as they rise above £2,000 a year; even when the business becomes a company this danger is not wholly averted, for the Inland Revenue keeps a close watch on undistributed profits of director-controlled private companies, and sometimes claims surtax on them. In any case, of course, profits tax hits companies hard.

Secondly, if a man ploughs back profits to buy some specialized asset for his business, that asset may be valued for death duty purposes at cost price less depreciation – despite the fact that its specialized nature makes it impossible to sell it at this price on the open market. This, however, is such an absurd anomaly – and it has so obviously held up desirable real investment in small businesses – that it is impossible to believe that it will not be rectified soon.[1] Some steps that are already being taken in the capital market to rectify such 'death duty problems' are discussed at the end of this chapter. Despite all these difficulties, ploughed back profits remain the principal source of finance for small businesses. It is probably mainly because net profits are prevented from being large – and partly also because of the death duty problems – that small businesses are not undertaking enough real investment today.

We must now turn, however, to outside provision of finance for small businesses. Under the third of the headings enumerated on page 114, we noted that many small businesses did not own the premises in which they operate, but rented them instead. Unfortunately, no statistics are available on this point, but there are three types of landlord to be considered. First, many businesses rent premises from other businesses; in particular, of course, larger businesses let out premises to smaller ones. Secondly, there are specialist property companies with a large stake in this field; the insurance companies have substantial property holdings (included under 'other assets' in Table X on page 82), and investment trusts and other financial institutions own and rent out some commercial and industrial property directly. Thirdly, Government departments are landlords to some businesses. One feature here has been the growth of trading estates in development areas; in order to encourage employment in these areas (which were called 'distressed areas' before the war) the Government has built and rented out factories with ancillary services on fairly favourable terms. Another recent feature is that the Ministry of Supply leased over 300 war-time arms factories to private concerns (mostly engineering concerns) in the first five post-war years. Not all of these leases, however, have gone to small concerns.

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[1] In fact, while this book was in the press, the 1954 budget provided that when a controlling shareholding in a small private business that has been valued for death duty purposes on an assets basis is sold to an independent purchaser 'the estate duty valuation of the shares actually sold shall be brought into line with the sale price'. In addition, Mr Butler reduced the rate of death duties on such industrial premises or plant or machinery by 45 per cent.

When a small business cannot rent its premises, it may buy them, but borrow on mortgage against them. The building societies concentrate on mortgage loans to private householders, but a substantial part of the £311 million of mortgage loans in the accounts of the insurance companies for end 1952 (see Table X on page 82) will have been loans on the industrial and commercial properties of small businesses. Some other financial institutions also make mortgage loans of the same sort, while some hire purchase transactions (our fifth category of finance, discussed in the next paragraph) represent purchases of buildings rather than of plant and equipment.

There are no satisfactory histories of, nor statistics about, hire purchase transactions in Britain; although the literature on this subject in America is voluminous. Hire purchase[1] originated out of straight sales of goods on credit – with the retailer giving credit to the consumer, or the manufacturer of machinery giving credit to customers who had small businesses. We need not follow the history of hire purchase in consumer goods (which is now, of course, very widespread indeed), but we may note that it was to help finance such contracts both in consumer and capital goods that the specialist hire purchase finance houses grew up. The growth of these specialist houses was a natural development, arising out of the economic division of labour; when manufacturers and retailers give credit direct, they need to make judgments about interest rates and credit risks – judgments for which they are not properly trained. The specialist finance houses are experts in this sort of business. They get the money to finance their transactions partly from their own issued capital, and partly from their own borrowing either on bank overdrafts or on bills drawn on London accepting houses (we will discuss the method of drawing such internal bills in the next chapter). The money concerned is then paid over to the seller of the goods, and it is a matter of choice between transaction and transaction whether the arrangement should be one under which the burden of chasing the eventual consumer for his instalments is laid upon the finance house or upon the seller of the goods.

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[1] Legally, a hire purchase contract is one where the purchaser pays by instalments and does not become the owner of the property until the last instalment is handed over, under a 'credit sale' agreement, ownership of property is transferred when the first instalment is paid, but the seller has the right to re-possess the property in the event of default. For our purposes, however, this legal distinction can be conveniently blurred

The biggest finance house dealing with hire purchase is the United Dominions Trust, whose other widespread activities will be discussed later in this chapter. It has, however, some forty sizeable (and perhaps two hundred very small) competitors. The total hire purchase agreements financed by eight of the biggest houses now exceed £40 million. In addition, of course, there are still large credit sales or hire purchase sales by individual manufacturers and suppliers directly (incidentally, the nationalized electricity and gas authorities make many of their sales of appliances on this system). It is impossible, however, to say how much capital equipment – as distinct from consumer goods – is sold on this system. Obviously the amounts concerned are not large compared with the total fixed capital assets of small business as a whole, but the field covered (stretching through engineering equipment, lorries, building, agriculture and many other branches of industry) is very wide.

The sixth source of finance, bank loans and other working capital (such as commercial bills and trade credits), will be discussed in the next chapter. We will see there that the total of such working capital available probably does not cover more than about 30 or 40 per cent of the total value of British business's stocks and work-in-progress. It follows that the other 60 or 70 per cent of these stocks and work-in-progress, together with the whole of business's fixed assets, must be financed out of ploughed back profits or other forms of long-term lending. The banks avoid, as far as possible, transactions that would cause them to lock up their funds in bricks and mortar; and it is in the country's interest that they should continue to do so.

The seventh source of finance for small businesses, as shown in our list on page 114, consists of private placings of shares which are not quoted on a stock exchange. Although a private company may not invite public subscription for its shares, the owner may circulate to a limited number of acquaintances with a view to raising new capital in this way; while public companies – and, as far as can be seen, considerably more than half of the 11,500 public companies in Britain do not have a quoted capital – have no legal difficulties of this sort at all. But the real problem is to find someone who will take up unquoted shares. Investment trusts, insurance companies and other financial institutions hold some unquoted shares, but their participation in this form of finance is not large. And private individuals who are willing to participate in this form of business are becoming rarer and rarer. Most people who are rich enough to feel able to put their money at risk in small ventures are people suffering from a high rate of income tax and surtax on marginal income, and they are thus more interested in scope for untaxed capital gains than in scope for higher current earnings. Since unquoted shares lack the great virtue of ready marketability, the prospect of easy capital gains is an attribute they do not offer.

It is not surprising therefore that the memorandum by the British Bankers' Association to the Royal Commission on Taxation (a memorandum which has been mentioned earlier in this book) showed that the share capital of the 1,500 private companies in their sample increased by only about £8 million to £56 million in the three or four years after 1946, while their ploughed back profits increased by over £25 million to £59 million and their bank overdrafts by some £16½ million to £30½ million. Moreover, part of the increase in share capital recorded in that memorandum will have represented capitalization of existing reserves into shares (some of which will then have been distributed to the principal owner's family); this sort of transaction – like the scrip issues of public companies discussed on pages 50 to 51 – does not add to the capital available for the business concerned. There are, however, no statistics of new capital raised by issues of unquoted shares by small companies in this way; nor yet of the eighth sort of capital provision noticed in our list (namely loans that are privately arranged for small enterprises through accountants, solicitors and so on).

The Specialist Institutions

There remains, therefore, the ninth source of finance, into which the seventh and eighth sources mentioned above imperceptibly merge. This source consists of loans to, or the taking up of unquoted shares in, small businesses by specialist institutions.

These specialist institutions first came into fashion between the two world wars. An early example was the Agricultural Mortgage Corporation, which was set up as a result of the Agricultural Credits Act of 1928 and which continues to be very active in making long-term mortgage loans to farmers. The corporation's capital was subscribed by the Bank of England and eight large commercial banks. A Government guarantee was provided for it, thus enabling it to raise funds by fixed interest issues on the stock markets at first-class rates; its lending charges to farmers are designed to give a sufficient 'turn' over these market borrowing rates to cover expenses.

Another body set up between the wars was the Special Areas Reconstruction Company, or Sara as it was promptly called. After the Macmillan Committee had reported on the need for financial facilities by small businesses, and at a time when unemployment in the 'distressed areas' was a grievous national sore, Sara was floated off in 1936 with a nominal capital of £1,000,000 (raised in the form of £900,000 of 3½ per cent cumulative preference shares and £100,000 of ordinary shares). Sara also enjoyed the promise of a State grant to help meet administrative expenses and a partial guarantee that capital losses would be covered out of the Government's budgetary funds. Its function was to provide finance for small businesses that might help to foster employment in the distressed areas, with the low figure of £10,000 as the normal maximum loan it might make to any one business. Sara did useful work in co-operation with the Nuffield Trust, the banks, insurance companies and other financial institutions (with the Treasury covering some of its expenses), but it was designed only to meet this one problem that was specific to the 1930s. Its most crowded hour of not very glorious life was between June 1936 and August 1937, when it lent some £400,000 to 67 different concerns; there will always be a debate about the lessons of its experience, but it was a political agency rather than an economic one and thus not a sensible example of what is needed in the capital market as a whole.

Of much more interest is the strengthening that took place between the wars of our old friend the United Dominions Trust. The U.D.T. was originally formed in 1919; it became a public company in 1925 and from 1930 to 1938 some of its capital was held by the Bank of England, which was eager to help this sort of financing facility in the depressed 1930s. As we have already seen, much of the work of the U.D.T. lies in the field of hire purchase. Originally it set out to offer finance to those engaged in the motor, engineering and allied trades – to enable them to sell their products on credit terms stretching over one, two, three or even more years. From this it branched out into financing the sales on credit terms of a wide range of manufacturers and merchants. It also runs a 'building plan' whereby property owners can pay a builder or contractor an agreed proportion of the contract price and accept bills for the balance; the U.D.T. will then pay the balance to the builder or contractor, raising the money for this by drawing bills itself or by bank borrowing. It runs a rather similar scheme to finance sales to farmers of livestock, farm implements, silos, barns and so forth.

The U.D.T. also has a number of subsidiaries under its wing. One of these is an issuing house to handle stock exchange issues and placings; another provides credit for the purchase of equipment by doctors and dentists; and yet another (the recently formed Transport Unit Finance Ltd.) was established to enable haulage contractors to purchase lorries and transport units from the British Transport Commission after de-nationalization. Perhaps the most interesting of U.D.T.'s subsidiaries for our present purposes, however, is the company called Credit for Industry Ltd. This was set up in 1934 as a direct response to the report of the Macmillan Committee. Its object is to grant loans ranging from £100 to £50,000 to small businesses. The loans are repayable over periods of up to 10 or 15 years; the security demanded varies (but in the case of a limited company may be a debenture and/or mortgage); and rates charged necessarily vary from transaction to transaction. Before granting a loan this company usually expects the approval of the borrower's bankers, and a recent brochure from the company suggested that its facilities 'can be particularly useful in the case of family concerns which are faced immediately, or likely to be faced in the near future, with a demand for death duties from the estate of the owner or part owner'. This special problem of death duties, and the financial facilities that are now sprouting up in London in an effort to meet it, will be discussed at the end of this chapter.

Another enterprise engaged in the provision of finance to small businesses is the Charterhouse Group. It was in 1934 that the Charterhouse Investment Trust, with the co-operation of the Prudential Insurance Company, Lloyds Bank and the Midland Bank, set up the Charterhouse Industrial Development Company. This company has since become the largest member of the Charterhouse group with an issued capital of £5,000,000. A recent brochure explains that it '(*a*) provides finance out of its own resources for smaller businesses in stages of development not yet large enough to attract capital through the machinery of the new issue market; (*b*) purchases the shares of private companies whose proprietors are faced with the payment of Estate Duty'. The company 'does not normally undertake business of a speculative character, nor the financing of new and untried processes or inventions' but confines itself to helping the expansion of existing undertakings. A favourite method is apparently to 'nurse' the shares of such expanding companies until the time has come when they can be floated off on to the new issue market; the Development Company has a wholly owned subsidiary that specializes in the sponsoring of such public capital issues. Among the firms that the Development Company helped to finance in 1952 or 1953 were a manufacturer of surgical lint, bandages and shrouds, a manufacturer of dairy requisites, a manufacturer of cardboard boxes and corrugated cartons, a wholesale grocer, and a timber importer. All these are obviously fields in which the small-scale business is as likely to thrive as the large-scale one.

The fact that the work of the United Dominions Trust (with its subsidiary Credit for Industry Ltd.) and of the Charterhouse

Group have been singled out for special discussion here does not mean that they are the only organizations in this field. Some of the big issuing houses will nurse small companies prior to a public issue of their shares, sometimes working in combination with investment trusts of other financial institutions. Two special nursing organizations that deserve mention are Private Enterprises Investment (recently formed under the sponsorship of four big merchant banks and of the Industrial and Finance Company Ltd., a member of the Issuing Houses Association), and the Glasgow Industrial Finance Company (formed by a group of Glasgow investment trusts). There is also a range of other financing concerns, shading off into some small businesses that are willing to 'have a go' in the financing of new and rather speculative investments. But there are not very many of them, and some may be rather queer fish.

If there was still a large reservoir of valuable business lying unsatisfied in this field, however, the success of those that are operating there should be great enough to attract a parade of new competitors. New competitors are indeed entering the lists, but not at the speed of a stampede. The awful suspicion therefore emerges that the extent of the 'Macmillan gap' may have been overestimated; and it is in view of this that the experience of the most important specialist experiment – the Industrial and Commercial Finance Corporation – deserves to be closely analysed.

The formation of the I.C.F.C. was announced in January 1945 when the war was drawing to its close. The initial announcement to the public declared:

> 'The provision of credit in "small" sums (say under £5,000) by means of banking advances provides no difficulty so long as the projects for which such credits are sought be economically desirable and commercially justifiable. For "large" capital requirements (say over £200,000) the Stock Exchange and other credit institutions provide facilities.
>
> 'The post-war finance requirements of industry and commerce may nevertheless call for the formation of a new institution specifically designed to provide medium-term finance or long-term capital for the smaller and medium-sized industrial or commercial businesses, where the amounts involved (ranging between £5,000 and £200,000) would not justify, or even possibly permit of, the making of a public issue of capital.'

For this reason, the announcement went on, it had been decided to set up I.C.F.C., which was to be a private company (but one that would publish a balance sheet and profit and loss account). Its nominal capital of £15 million would be subscribed by the English and Scottish banks (plus a token subscription from the Bank of England), and called up as required. In addition I.C.F.C., would be allowed to borrow up to £30 million from its shareholder banks, so that its total resources could reach £45 million.

In the first eight and a half years of its existence (up to the end of March 1953), however, the company utilized only £25¼ million of these total borrowing powers of £45 million; it called up £7½ million of its £15 million of capital, and borrowed £17¾ million of its authorized loan capital of £30 million. Together with just over £1,000,000 lent out of its own reserves, it had therefore pushed its total loans and investments up to only £26.3 million by the end of March 1953; of these, just over £10½ million was out on secured loans, just over £5½ million on unsecured loans, just under £8 million was held in preference shares and just over £2 million in ordinary shares. The number of customers' accounts open at this time was 426 (but 71 accounts had been closed by repayment or otherwise since the corporation's inception, and a start had been made in floating off those companies that had been successfully nursed up until they were ripe for public issues).

As some indication of the scale of demand, the corporation received 416 applications for advances or investments in the year to March 1953 (some of them obviously from cranks); it accepted 64 of these applications to a total of £4,085,200 of new business – 42 of the customers getting loans under £50,000, 10 of them between £50,000 and £100,000, and 12 over £100,000. I.C.F.C.'s gross income from its £26.3 million of invested funds in 1952–3 was £1,602,192; but the corporation had to write off £100,000 against doubtful advances and investments. Nevertheless, this still left enough for the corporation to pay its first dividend (of 4 per cent, less tax) to its shareholder banks, and to add moderately to its reserves. It has clearly been well-managed and the figures suggest that, while it has not taken undue risks, it has certainly not been so tight-fisted in its interest rate or 'vetting' policy as to make large profits. Why, then, did it only find itself required to make £26.3 million of loans and advances in these eight and a half years, out of the £45 million it could have produced?

The answer may be found in a statement made by the corporation's chairman, Lord Piercy, at the peak of the boom in 1951:

> 'We do not expect of course to be the residuary legatee of all the requirements for capital funds which are not carried on bank advances or met by the issue market; but since we undertake every proposition that we reasonably can, our experience has some evidential value. I would say then that from our experience, the small and medium industrialist has not been avid for finance for new fixed capital. This concurs with my general impression that the new investment in general manufacturing industry from 1946–50 was not large; there was perhaps no net excess over renewals and replacements of old plant and repair of war damage. The recent sample enquiry of the Board of Trade into Capital Expenditure by Manufacturing Industry in Great Britain during 1948 and 1949, though statistically perhaps not very solid, leaves the same impression on my mind; and a sample enquiry by the F.B.I. seems to show that the big fellows – 90 companies representing £1,000 million of assets – held in real physical terms at the end of 1949 a slightly lower amount of fixed assets than in 1938. Working capital – in the last year or two – is a natural, convenient and main resource; and the inducement to go for additional permanent resources is weakened by fiscal conditions. Preference capital, at say 6 per cent, costing with profits tax the equivalent of 9 per cent,[1] is a bold step-up from the prevailing rates for bank accommodation where an industrialist can legitimately satisfy his needs in that way.'

It seems evident from this statement that the disturbingly low level of real investment in small British businesses today is not due merely to lack of investible funds but to the lack of incentive to expand business activity under conditions of crippling taxation. If the tax system were revised so that profits were not so heavily mulcted, then the demand for investible funds in this sector might again prove so great that I.C.F.C. and its competitors would be insufficient to assuage it. But, for the moment, real investment is being destroyed before conception, not strangled at birth. The proliferation of new specialist institutions in the field of the 'Macmillan gap' would be unlikely to lead to a magic revival of small business so long as these conditions persist.

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[1] Distributed profits tax at this time was 50 per cent.

The Death Duties Problem

There remains, then, one particular problem that deserves attention here, because it is a clear subsidiary factor in holding down the rate of real investment in these smaller businesses. This is the problem of death duties. Small businessmen have long been frightened of expanding their concerns beyond the size where control over them can be kept in their own families – on the view that expansion beyond this point leads to a fundamental change in the character of the concern. This critical point, beyond which expansion is considered dangerous, has been pushed lower down the ladder of industrial activity by the operation of death duties.

This is not the place to discuss the anomalies that are claimed to exist in the tax laws and that seem to make the burden of death duties upon small businesses especially stringent. There is some evidence, however, that death duties, besides certainly holding down the level of new real investment in small businesses, is also actually whittling away the assets that have been built up in these businesses in the past. This evidence can be found in a document that was designed for precisely the opposite purpose, namely an Inland Revenue report (published in 1951 as Cmd. 8295) on an examination of the assets of small businesses assessed for death duties in 1948. The enquiry found that there were some 1,790 estates assessed in that year which amounted to over £20,000 and which included trade assets (including shares of private companies) of over £1,000. It found that, at the 1951 rate of death duties, the payment of duty without some encroachment into trade assets would be impossible in 204 (that is, 11.4 per cent) of these 1,790 estates.

The methods of compilation used in Cmd. 8295 have been very sharply attacked – most notably in a report drawn up by the *Economist* Intelligence Unit for the National Union of Manufacturers. This report declared, first, that although the rates of duty assumed in Cmd. 8295 were those of 1951, the values on which they were notionally assessed had not been written up to allow for the price inflation between 1948 and 1951; secondly, that Cmd. 8295 assumed that the whole of the non-trade assets in any estate would be devoted to payment of Estate Duty before trade assets were called upon to contribute their share – in other words that the deceased's family would be deprived of house and furniture and left on the streets before a business was broken up; and, thirdly, that in 80 per cent of the estates analysed in Cmd. 8295 non-trade assets exceeded trade assets – a fair figure perhaps for the businesses whose owners died in 1948 (most of whom, being older men, would have built up their businesses before the war) but a quite absurd proportion for businesses being built up today. No small entrepreneur building up a new concern in the post-war world can afford to take more than 50 per cent of his after-tax profits out of the business.

The suspicion has also been mooted that some estates that were particularly hard hit by death duties (and about the assessment of which the deceased's heirs were fighting the Inland Revenue) had been left out of the reckoning when Cmd. 8295 was drawn up. The *Economist* Intelligence Unit argued therefore that Cmd. 8295 made a gross under-estimate when it said that only some 11.7 per cent of private companies whose assets lay in these large fortunes had their activities interfered with by the operation of death duties. The proportion, it believed, was much heavier than this. It is quite possible, in fact, that in an actual majority of small businesses in Britain development is held up at some stage or another, for fear that full-scale ploughing back of profits will cause the owner's family to be left with too many unrealizable assets – and thus too large an obligation to cut grievously into their standard of living – when the blow of death duties falls.

At the moment of writing a Government committee is enquiring into all this,[1] and it remains to be seen whether it will recommend some less stringent way of assessing the value of a private company's shares for the purposes of death duties. Meanwhile, however, one step has been taken towards the solution of this problem. In early 1953, a small company known as the Estate Duties Investment Trust Company (and inevitably nicknamed 'Edith') was set up; it has a capital of £1 million subscribed by seven leading insurance companies and by a number of investment trusts, and it is managed by the I.C.F.C. 'Edith' is designed to act as a neutral shareholder in private companies faced with the threat of disruption as a result of Inland Revenue demands for death duties; the shares it buys will be regarded purely as investments and there is no intention to float them off on the ordinary capital market after appropriate nursing. In other words continued family control over these businesses will be assured. Edith is not alone in her field; some private enterprise concerns, including the Charterhouse Industrial Development Co. (described above) and a company called Safeguard Ltd. (sponsored in 1953 by a member of the Issuing Houses Association, the London and Yorkshire Trust, with a capital of £1,300,000) are also operating in it. These bodies have an immense field in front of them, and one that may become increasingly important as the years roll by.

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[1] For the ameliorations that were in fact announced in the 1954 budget, see footnote to page 115.

CHAPTER X

FINANCE FOR INDUSTRY

II. BANK ADVANCES AND OTHER FORMS OF WORKING CAPITAL

So much for the problems of setting up a small business, of keeping it in being under present conditions when taxes (including death duties) are so high, and of financing its expansion up to what we have called the 'barrier' and what other people have called the 'Macmillan gap'. In this chapter we will discuss how businesses, both large and small, can raise short-term or 'working' capital. In the next chapter we will discuss a special type of working capital, namely working capital that is needed for the finance of international trade. Then, in Chapter XII, we will go on to discuss how larger businesses may finance their long-term expansion, once they are on the other side of the 'barrier' or 'gap'.

By working capital we mean the money that businesses have to raise to pay their wage bills, to buy raw materials and so forth. In any factory at any one time there will be a stock of raw materials, of half-finished goods, and of finished but unsold goods on which the business has spent money (including the wages of employees who have been working on the half-finished or finished goods) but has not yet earned any money from sales. As we saw in Chapter II the total value of such 'stocks and work-in-progress' in Britain at the end of 1952 was estimated by the national income statisticians at about £7,300 million.

There are four main ways in which businesses can borrow money to meet working capital commitments of this sort:

(1) *Bank Advances.* Figures published by British Bankers' Association suggest that there were between £1,800 and £1,850 million of bank advances outstanding in Great Britain at the end of both 1952 and 1953. These are therefore the most important source of working capital finance.

(2) *Commercial Bills.* These are arrangements whereby a business selling goods to another business can draw up its bill in a way that allows the purchaser to pay for these goods in three months' time (or even later). If the purchaser's name is of good

standing, an accepting house or bank in the City of London may be induced to 'accept' the bill – that is, to guarantee that the money will be paid over to whoever holds the bill at the date of maturity promised. In these circumstances the bill can be sold (as a profitable, short-term investment) to a London discount house or bank. Commercial bills are most important in the field of international trade, and they will be fully discussed in the next chapter. In this chapter we shall concentrate on discussion of their use in domestic trade and on a rough estimate of their importance as a source of working capital as a whole. We shall see that total commercial bills (both external and internal) outstanding at various stages in the financial year 1951–2 averaged around £575 million. Probably, however, only about £250 million of these were bills on which the banking system was advancing finance; the others were mostly just stamped debts from one business to another, and could not be regarded as a net source of finance to British industry as a whole.

(3) *Trade Debts and Inter-Company Loans*. Trade debts simply represent goods or services that have already been sold but not yet paid for; although a business that manages to owe more debts than it has owing to it gets some relief towards meeting its own working capital commitments, this system cannot, of course, provide any net finance for British industry as a whole. Under the heading of inter-company loans we include both deliberate loans by one company to another (often a subsidiary or a business with which the lending company has close connections), and the progress payments that are often made in advance of delivery by businesses that have ordered ships or other heavy engineering equipment. Once again no net finance to British industry as a whole is forthcoming from such transactions.

(4) *Uncollected Taxes*. Finally, as we saw in Chapter II, at any one time British industry usually has fairly substantial tax obligations outstanding which the tax authorities have not yet got around to collecting. If these funds are used to finance working capital commitments, they can be regarded as borrowing from tax reserves – that is, as a sort of indirect, short-term borrowing from the Government. It is not possible to make any assessment of the average amount of such borrowing; indeed there is really no such thing as an average, because the total varies wildly not only from year to year but from season to season – being lowest just after the peak tax-collecting season of January to March.

But, at times, the amounts outstanding are substantial.

Nevertheless, it seems unlikely that borrowing under these four heads (bank advances, commercial bills, trade credits and tax reserves) can normally cover more than about 30 or 40 per cent of British business's working capital commitments. Indeed, it may well cover less than that. For comparison must not merely be made between borrowing from tax reserves, bank advances (around £1,800–£1,850 million at end 1952) and borrowing from the banking system on commercial bills (probably around £250 million at end 1951, though less by end 1952) on the one hand, and the £7,300 million odd of working capital commitments at end 1952 on the other. Account should also be taken of the fact that some of Britain's working capital funds are almost certainly used to carry the net short-term trade debts that are owed to British business men from abroad; in other words there are usually more British exports that have been shipped but not yet paid for by remittances to this country than there are British imports that have been received but not yet paid for by remittances from this country. This, of course, is merely another way of saying that London is still an important international financial centre; and Britain enjoys substantial interest receipts from this short-term commercial lending. But while studying the various sources of working capital below it is as well to remember that they probably cover – and indeed ought to cover – only about a third of the country's total working capital commitments. The rest has to be covered out of ploughed back profits or other forms of longer-term savings.

Bank Overdrafts and Loans

Of the various sources of working capital, it will be seen from the above figures, bank advances are by far the most important. These advances may be made either by way of overdraft or (less commonly in Britain) by way of loan. Under an overdraft arrangement, the bank agrees to honour its customer's cheques until further notice up to an agreed limit; the customer then pays interest only on his net daily debit balance, so that he never finds himself paying interest on funds that he does not use. Under a loan agreement, a fixed sum is paid over to a customer's credit account and he has to pay interest on that fixed sum quarterly or half-yearly; obviously this is usually less convenient for the borrower than an overdraft arrangement, but sometimes a bank will insist upon a loan arrangement (for example, when the company's articles fix a limit to the amount that the directors can borrow, and when the bank fears it might be caught if the company exceeds this limit).

Interest rates are usually slightly higher on overdrafts than on loans, but exact figures are not published. Most overdraft rates, however, now seem to be tied to some stated relationship with the Bank of England's so-called Bank rate (which we will discuss later in this book). A fairly general pattern seems to be for the nationalized industries and a few other favoured borrowers to get their overdrafts at Bank Rate itself; for other fairly large or medium-sized businesses to get them at between ½ and 1 per cent over Bank Rate; and for personal or small business borrowers to get them at 1½ per cent over Bank Rate or a little more. Most of these overdraft agreements, however, set minima below which rates will not be allowed to fall. In mid-1954, when Bank Rate had come down to the low level of 3 per cent, many of these minima were believed to be in operation. At that time the nationalized industries and most sizeable business borrowers were believed to be getting their overdrafts at rates ranging between 3 and 4 per cent, and most smaller businesses and personal borrowers at rates ranging between 4½ and 5 per cent.

When will a bank make a loan to a business and when will it refuse? If, as is usual, the business pledge is a security or deed over which the bank secures a direct charge, the bank will be less exacting than in the case of an unsecured advance. But even in this case, since a banker does not like to make loans that will only be repaid by realization of the security, the bank will look closely at the purpose for which the advance is required, the question of whether the use of the funds will be profitable to the borrower, and the period for which the advance is required (with a general rule, the shorter the better). Above all, the bank will also look closely at the business's balance sheet; the orthodox banking text books tell aspiring bankers that the prudent limit of an unsecured advance is up to a third of the surplus disclosed by a break-up valuation of a balance sheet, that is to say up to a third of the amount that would be available for repaying the bank if the business had to be sold up and all prior debts were met. The catch is, however, that the banks assess these break-up values very conservatively. For example, the break-up value of plant and machinery might be estimated at only 20 per cent of balance sheet valuation, the break-up value of holdings of raw material stocks at only 50 per cent of current market value, although the break-up value of holdings of British Government securities would be valued at very near their current market price.

There is an added complication here. Since the war the Treasury has asked banks to scrutinize requests for advances to make sure that the use to which they are put accords with the national interest as well as with sound banking criteria. There is no doubt that the banks have tried loyally to abide by this request all through the post-war period, although – as we shall see in Section II of this book – it seems certain that the tightness of a bank's scrutiny inevitably tends to vary more with the ease or tightness of its own 'loaned-up position' than with that of the official directives.

Commercial Bills

The commercial bill is a very old-established method of raising working capital, especially in the export and import trade; as such we will discuss it fully in the next chapter. But the commercial bill is also used in purely internal transactions. The simplest case is that of a British business that is selling certain raw materials to another British business. The purchaser will not want to pay for these raw materials until he has made them up into finished goods and sold them. The seller can then go along, say, to an accepting house in the City of London that specializes in this type of business and say 'My customer does not want to pay my bill for these goods for another three months, but I want my money now.' If both the seller and the customer are of good standing, the accepting house may (on payment of a commission) 'accept' the bill – that is to say, guarantee that the sum stated will be paid to whoever holds this bill in ninety days' time – and give it back to the seller. The latter can then sell the bill for near its face value (less three months' interest) to a London discount house or to a banking house. If the name on the bill is that of a first-class 'acceptor' – Rothschild or somebody like that – the bill will be a 'fine bank bill' and readily saleable at the best rates.

From this it is but a short step to drawing up a bill even when no detailed arrangements have been made to sell the goods concerned. For example, a British manufacturer who has to make heavy purchases of raw materials at one particular season and then uses those materials for processing throughout the year can often arrange with a London acceptance house that it will accept his bills drawn at, say, '90 days after sight'. In this case, the manufacturer may not know exactly to whom he is going to sell his processed goods, but he may convince the acceptance house that the goods will certainly command a ready market. When the acceptance house has agreed to this, the bill can be sold to a discount or banking house that will pay cash into the manufacturer's banking account. The manufacturer, of course, has to pay over the funds when the ninety days are up, but often he is allowed by the acceptance house to go on drawing new bills on a sort of revolving credit line.

Bills drawn by one British trader upon another are even easier to understand. In effect, instead of sending an ordinary demand note along to his customer saying 'pay me at once', the manufacturer sends a bill saying 'pay me in (say) ninety days' time'. If the customer accepts this – i.e. agrees that he will pay – this becomes a 'trade bill' which can (if the credit of both parties is good) be sold in the discount market. Obviously, however, the discount market will not pay as much for a bill of this sort as for one that has been accepted by a London bank or acceptance house; often, therefore, it is worth-while for a trader who gives much credit in this way to have a line of acceptance credit opened for him at a bank or acceptance house. Incidentally, bills that are drawn not to finance the movement of goods from one place to another (as most international trade bills are) but to finance the carrying or processing of goods (as many internal bills are) are usually known in the City as 'finance bills'; they are not regarded with such favour as the other type of bills, and they are not always so easily rediscountable at the Bank of England.

How important an instrument of finance are these commercial bills? They used to be a very important instrument indeed. Some estimate of the total bills stamped in any one year can be deduced from statistics published by the Inland Revenue, which are regularly analysed by one of the discount houses (Jessel, Toynbee & Co.). These figures, which include international trade bills as well as purely domestic bills, show that at the peak of the boom of the 1920s, commercial bills were nearly as important an instrument of finance as bank advances. Full figures for some interesting recent years are as follows (in £ million):

	1928–9	1929–30	1933–4	1944–5	1951–2
Average amount of stamped bills outstanding	738	575	245	42	575
Average of clearing bank advances[1]	948	991	759	750	1,822

[1] Calendar years 1928, 1929, 1933, 1944 and 1951 for bank advances.

There are three points, however, that should be noted about these statistics. The first is that probably less than half of the bills stamped can be regarded as first-class (or even nearly first-class) paper of the sort described above; the actual amount of first-class commercial bills held by the clearing banks (the main holders) at the end of 1951 was only £181 million. Secondly, bills tend to decline more swiftly than advances in any period of disinflation or less robust trade: thus between the end of 1951 and the end of 1952 the commercial banks' holdings of commercial bills fell by nearly two-thirds, from £181 million to £66 million, while their advances fell by less than 10 per cent. Thirdly, although the total supply of commercial bills had by 1951–2 recovered from its war-time nadir to its 1929–30 level, there had been an interesting swing towards using the bill as source of internal rather than of international trade. One sign of this was that £363 million of the £575 million of bills deducible from Inland Revenue figures in 1951–2 were inland drawn (compared with £203 million in 1929–30), while only £212 million were foreign drawn (compared with £372 million in 1929–30).

This growth of internal finance by bills was not wholly pleasing to the Bank of England, which has been accused at times of taking steps that are detrimental to the bill on London (apparently because it finds this type of lending less easy to control than bank advances). Thus, as we shall see in Chapter XIX, the Bank used its power of moral suasion to keep the discount rate on commercial bills as high as 3 per cent throughout most of 1952 and 1953, at a time when the acceptance houses and most of the discount houses wanted it lowered; it also imposed certain restrictions on the types of bills that could be drawn (see Chapter XI) at the worst phase of Britain's post-war balance of payments crisis. This 'imposed' rate of 3 per cent on commercial bills made it very expensive to borrow on this instrument. The commission charged for acceptance by the merchant banks to first-class businesses at this time was around 1½ to 2 per cent (with a few businesses even having to pay up to 3 per cent); to this there had to be added the Inland Revenue's stamp duty of 0.2 per cent per annum, making a total cost per bill of around 4.7 to 5.2 per cent per annum, for first-class concerns. Since many of these concerns could borrow on bank overdrafts at 4½ per cent at this time (see page 131) – and since on overdrafts, as distinct from on bills, they need only pay interest when they actually draw out the money for use – it is not surprising that there was a heavy fall in the number of bills outstanding in this period. But when Bank rate was reduced by ½ per cent in September 1953 – and when, in consequence, most bank advances rates fell by ½ per cent – the discount rate on commercial bills was set free to be determined solely by market influences. It fell at once by $\frac{13}{16}$ per cent, to $2\frac{3}{16}$ per cent, and borrowing on commercial bills again became competitive with borrowing on bank advances.

There is one final statistic that deserves to be noted before leaving the question of commercial bills for a time. We have seen above that when a business wants to raise money on a commercial bill it seeks for:

(*a*) somebody to 'accept' or 'guarantee' the bill by lending his name to it and

(*b*) somebody to sell that bill to.

Bills are usually sold either to a discount house, which usually re-sells them to a bank (for discount houses hold comparatively few commercial bills in their own portfolios); or else – under certain circumstances – direct to a bank. What, however, of the pattern of acceptances? Here the only figures we have available are those provided by Jessel, Toynbee & Co. for the bills that pass through their hands. In the year to March 31st, 1953, Jessel, Toynbee reported that 71 per cent of the bills passing through their hands had been accepted by fifteen acceptance houses (or, as we have seen that they are also called, merchant banks), 8 per cent by clearing and Scottish banks, 3 per cent by Dominions' banks, 3 per cent by English banks operating abroad, 2 per cent by United States banks and 5 per cent by other foreign agencies:

that left just under 3 per cent that were trade acceptances and just under 6 per cent that were described as 'miscellaneous acceptances'.

Trade Credits

This description of the function of commercial bills to some extent dovetails into any description of the function of trade credits; for some trade debts shown in businesses' balance sheets actually represent borrowing on bills. But, obviously, not all of them do. We have already seen, in Chapter V, that the public companies whose balance sheets were analysed by the *Economist* in 1952 had more than £3,000 million of creditors and short-term liabilities outstanding. For private companies our best source of information lies, once again, in the balance sheets of 1,500 private companies (most of them with a capital of below £100,000) that were analysed by the British Bankers' Association in its memorandum for the Royal Commission on the Taxation of Profits and Income in 1951. These 1,500 companies had £69½ million of trade debts outstanding against £65½ million of trade credits to come in.

It is a little surprising that these small private companies had nearly as much due to come in on trade credits as they had due to go out on trade debts; the pattern one would expect is for the bigger and stronger companies to extend trade credits to the smaller and weaker. There is also something rather unhealthy in the expansion of trade credits and debts in recent years. When it becomes difficult to sell goods to distributors and others, some small concerns are apt to sell an unduly high proportion of their goods 'on tick'. They cannot always be very well aware of the true strength of those distributors' financial position, and if ever market conditions turned really sour there might conceivably be a frightening eddy of disturbances in the business world due to this factor. Admittedly, borrowing on trade credits can sometimes be very expensive. Some manufacturers offer a discount of somewhere between 2 and 4 per cent to customers who settle their accounts promptly – perhaps giving them a three months' period of grace in which to pay. A discount rate of between 2 and 4 per cent for three months is equivalent to an interest rate of between 8 and 16 per cent per annum. A business concern that borrows from its bank at 3½ or 4 per cent and then sells on these terms may seem to be doing good business, but if ever bad debts become as frequent as they were before the war the position of some people who have made large sales on credit in this way may become very uncomfortable.

Other Forms of Working Capital

There are two other forms of short-term finance that deserve to be noted. In the first place, the increasing trend towards integration in industry has meant that many small concerns are often in the same group as bigger companies that buy from them. A big tobacco company, for example, may own the majority of shares in subsidiaries making cartons, cigarette paper, etc.; and it may be willing to lend to them when they are in need. Not all of these inter-company loans are necessarily on a short-term basis. As already explained, too, some manufacturers making custom-built items such as ships demand progress payments as a source of working capital.

Finally, as we saw in Chapter III and noted at the beginning of this chapter, most companies in effect borrow large sums from the Government, because they pay their taxes some time in arrear. Under its present system of organization, the Inland Revenue collects the majority of company profits and income taxes in the first three months of each calendar year; these collections may refer to profits earned several months beforehand. The effect of this is particularly notable in years of inflation when profits – including the quite specious profits arising from stock appreciation income discussed in the footnote on page 46 – rise substantially. In the inflation of 1951, for example, according to the national income figures, the gross profits of companies rose by £493 million (with the stock appreciation income of companies in that year equalling £500 million); against this, company tax payments actually fell by £72 million, but no less than £492 million (against £59 million the year before) had to be added to the companies' already large reserves awaiting disbursement for future tax payments.

What happens to all this money awaiting disbursement as taxes? The memorandum by the British Bankers' Association to the Tax Commission, already cited, declared soberly: 'The experience of the banks does, in fact, show that sums held for payment of taxes are commonly used as working capital until paid over, when they have to be replaced by borrowing, probably from the banks.' Once again, this is obviously not a very healthy position.

Should the Banks Lend Less Cautiously?

Such, then, are the sources of short-term loans or 'working capital' in Britain today. The essential point to notice is that no business can or should rely on short-term loans to carry its expansion very far. We suggested at the beginning of this chapter that probably only about 30 or 40 per cent (or even less) of Britain's total working capital commitments are covered by short-term loans through the media we have been discussing here. It would be a great pity if a much larger proportion was so covered. Prices of raw materials are very volatile and losses on stock can therefore be very heavy. If each time such losses were made some companies found they could not repay their short-term debts that would be a recipe for recurrent financial panics.

There are therefore no grounds at all for suggesting that there is any 'gap' in the mechanism for provision of working capital in Britain. The only argument that is sometimes heard in this field is that the banks should not restrict themselves to making short-term loans for the financing of true working capital requirements, but should make longer-term loans for the financing of operations that cannot be called true working capital requirements at all. Indeed some people say that this is happening to some extent already. They claim that the banks do in fact lend more for fixed capital formation than they like to admit; and certainly one can cite many recent balance sheets which have shown stock values down, but both fixed capital equipment and bank loans up on the year before.

The answer to this debated question, however, can probably best be found by looking back to what we said earlier in this chapter about the criteria on which the banks decide whether they can or cannot allow a loan. The banks are not always excessively finicky about the way in which each pound they lend is invested by the borrower. Certainly they prefer the money to be invested in some self-liquidating transaction; and, if it is obviously being invested in bricks and mortar instead, they suggest that the borrower should raise long-term capital on the market and thus repay their advance. But what banks usually are very finicky about is to see that their contracts allow them to call loans for repayment at relatively short notice, and that they should not lend more to any one customer than their conservative assessment of the break-up values disclosed in his balance sheet suggest could swiftly be repaid in the event of emergency. Those who call for a bolder lending or investment policy by the banks, to meet the emerging risk capital crisis, are in effect suggesting that these two criteria should be thrown to the winds.

This seems a most undesirable suggestion. The risk capital crisis, as we have discussed it so far in this book, emerges from the fact that more and more of the people who are saving today want or need to keep their savings in a very safe and very liquid form. One of the safest and most liquid forms of all is saving through additions to commercial bank deposits. If these savings were then immediately re-lent by the banks to the riskiest small concerns or invested in the most risky forms of industrial security, commercial bank deposits would no longer be one of the safest and most liquid forms of saving; and other safe and liquid forms would be invented to take their place. Moreover, it would be absurd to tell bank managers up and down the country that some, but not all, of their funds could now be invested in the riskiest type of enterprise, with traditional balance sheet valuations thrown to the winds; bank managers just are not trained to operate that way – and there would be wild variations in the interpretation that they would put on any such order. Finally, as we will see in the second section of this book, one of the quickest ways in which the authorities can cut down the country's spending at a time of emergency is by taking certain steps that make the banks more cautious in their lending policy; if the banks' conservative system of balance sheet valuation were overthrown, so that certain concerns which could not find accommodation elsewhere in the capital market became even more dependent on the banks than they are now, monetary discipline in times of emergency could not be imposed without a clatter of bankruptcies and financial panic all over the land.

If ever concessions on income and profits tax should make more real investment profitable, and if the effective 'Macmillan gap' should then become bigger than it is today, the proper way to meet it will certainly not be by an extension of bank lending direct to those who are searching for long-term funds. The proper way – to enable division of labour to be accomplished while the banks can spread their risks – might be by an extension of bank lending to specialist institutions such as the I.C.F.C. The short cut to direct bank lending (or to direct bank holding of equity shares) could easily be a short cut to financial disaster; and we can be quite certain that British banks are not going to take it.